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Redlining in Mortgage Lending: California's Approach to Getting the Red Out

The California State Legislature has recently declared that the subject of housing is of vital statewide importance to the health, safety, and welfare of the residents of this state.¹ The legislature also declared that the national housing goal of providing a decent home and a suitable living environment for every American is a priority of the highest order.² One of the obstacles to achieving this goal, however, is that private lending institutions have been unwilling or unable to commit sufficient funds for residential mortgage financing in certain geographical areas throughout the state.³ Mortgage financing is denied in these areas regardless of the creditworthiness of the individual loan applicant. This denial of mortgage financing makes the decline of the affected neighborhoods inevitable, because the residents are unable to sell their homes except to a buyer who can pay cash, and the residents are also unable to obtain home improvement loans to maintain the condition of their property. This practice by financial institutions of denying mortgage financing because of the neighborhood in which the property is located has been termed "redlining."

"Redlining" is defined as the policy of lending institutions either to exclude certain geographical areas from consideration for home mortgages and rehabilitation loans, or to vary the terms and conditions of such loans within certain geographical areas.⁴ The legislature has expressly recognized that redlining exists in California.⁵ In Section 42000 of the Health and Safety Code, the legislature states that for reasons of prudent investment policy, private financial institutions are not making mortgage financing available for residential structures located in many older residential neigh-

1. CAL. HEALTH & SAFETY CODE §41001.

2. CAL. HEALTH & SAFETY CODE §41002. This national housing goal was adopted by the legislature as it applies to California, with the accompanying commitment to "guide, encourage, and direct where possible, the efforts of the *private* and public sectors of the economy to cooperate and participate in the early attainment of a decent home and a satisfactory environment for every Californian." CAL. HEALTH & SAFETY CODE §41001 (emphasis added).

3. CAL. HEALTH & SAFETY CODE §41003(c).

4. Comment, *Redlining: Potential Civil Rights and Sherman Act Violations Raised by Lending Policies*, 8 IND. L. REV. 1045 (1975).

5. CAL. HEALTH & SAFETY CODE §42000.

borhoods, or for certain housing developments occupied or intended to be occupied by substantial numbers of low or moderate income families because of the perceived risks that such loans entail. In using the term "perceived risks," the legislature is implicitly recognizing that, in fact, such risks may or may not exist.

In the Health and Safety Code, the legislature also states that the lack of mortgage financing in certain neighborhoods has caused and contributed to deterioration of residential neighborhoods, inhibited local governments in their attempts to arrest and reverse deterioration through local code enforcement programs, and generally reduced or limited the supply of safe, decent, and sanitary housing available to persons and families with low or moderate income.⁶ Lieutenant Governor Mervyn Dymally of California has stated the effects of redlining in even stronger terms.⁷ He stated that the practice of redlining sounds the death knell for many of our inner cities. Not only does it stop people from obtaining loans to purchase a house, but it also prevents people from securing loans to improve the condition of their present home.⁸

There is almost universal consensus that the availability of home loans is essential to the preservation of California's existing housing stock.⁹ In fact, the legislature has stated that in order to remedy the housing shortages which exist in California, it will be necessary to make mortgage financing available in redlined areas.¹⁰

The consensus collapses, however, when attempting to allocate the responsibilities and the risks of making mortgage financing available in redlined areas.¹¹ Public interest and community action groups place the responsibility for resumption of mortgage lending on the financial institutions, arguing that since the financial institutions have taken money out of communities in the way of deposits, the financial institutions should now reinvest that money by making local home loans rather than "disinvest" by financing projects outside of the redlined communities.¹² However, financial institutions have resisted the definition of the institution's lending policies by public interest groups. The financial institutions look to the government to cover any prospective loan applicant that the financial institution considers to be high-risk.¹³

6. CAL. HEALTH & SAFETY CODE §42000(a).

7. *Special Hearings on Redlining Before the State of California Business and Transportation Agency* [hereinafter cited as *Redline Hearings*], June 16, 1975, no. 1, at 1 (copy on file at the *Pacific Law Journal*).

8. *Id.* Even if a person is lucky enough to secure a loan, it will be at a higher interest rate. Dymally states that no one practice currently inflicts so much damage on the working of the inner city as redlining. Redlining quashes the hope of people - the dream of someday owning their own home and being able to say, "This is all mine." *Id.* at 1-2.

9. Comment, *Urban Housing Finance and the Redlining Controversy*, 25 CLEV. ST. L. REV. 110, 111 (1976).

10. CAL. HEALTH & SAFETY CODE §41003(c).

11. Comment, *Urban Housing Finance and the Redlining Controversy*, 25 CLEV. ST. L. REV. 110, 111 (1976).

12. *Id.*

13. *Id.*

This comment will first examine what constitutes redlining, the effects of redlining on a neighborhood, and the extent to which redlining exists in California. The comment will then discuss the problems the public has in obtaining information on redlining practices by financial institutions due to the subtle nature of some of the practices. Recent legislation requiring disclosure by financial institutions will be analyzed, and recommendations will be made for simplifying the public disclosure process.

An examination of the legality of redlining under state law and federal civil rights statutes will illustrate what can be done to eliminate redlining in California. A determination will then be made whether financial institutions can justify redlining practices by the affirmative defense of business necessity. The comment will conclude by examining what the State of California has done to assist financial institutions in making loans in redlined areas.

EFFECTS OF REDLINING

Any discussion of redlining must necessarily begin with a definition of redlining, an examination of its adverse effects, and a determination of the extent to which redlining is practiced in California. The term "redlining" originally referred to a financial institution's¹⁴ alleged practice of drawing a red line around an area on the map of a city and deciding that no funds would be made available for that area.¹⁵ The typical redlining process today is not so graphic or demonstrable that a lender draws red lines on maps and rules out any investment in those areas; the process is more subtle.¹⁶ Today a financial institution "redlines" a certain area within its service area whenever it engages in any of the following practices: (1) refusal to accept applications for loans or to grant loans secured by real property within the designated area; (2) refusal to make a loan secured by real property within the designated area unless the loan is guaranteed by some form of mortgage insurance, either public (FHA or VA) or private; or (3) granting loans secured by real property within the designated area only on more onerous terms and conditions than those for loans on residential property outside the designated area.¹⁷

Testimony at hearings conducted by the California Business and Transportation Agency in 1975¹⁸ [hereinafter referred to as Redline Hearings] indicates that redlining is a widespread practice in this state, and that each of the aforementioned practices is employed by California financial institutions.¹⁹ While representatives of lending institutions denied that loans were

14. "Financial institutions" in this context refers to savings and loan associations, banks, mortgage companies or any other institution that regularly makes mortgage loans.

15. Comment, *The Legality of Redlining Under the Civil Rights Laws*, 25 AM. U.L. REV. 463, 465 (1976).

16. *Redline Hearings*, *supra* note 7, June 23, 1975, at 37.

17. Renne, *Eliminating Redlining by Judicial Action: Are Erasers Available?*, 29 VAND. L. REV. 987, 990 (1976).

18. See note 7 *supra*.

19. E.g., *Redline Hearings*, *supra* note 7, June 16, 1975, no. 1, at 4-5, 16-19; *Redline*

refused solely on the basis of geographic location,²⁰ a number of witnesses testified that after identifying only the address or the zip code of their property, they were told that no money was available for loans in that area.²¹ Other witnesses also emphasized that loans are being denied solely because of the location of the property.²²

Financial institutions also engage in redlining by requiring that mortgage loans be insured by FHA or VA rather than granting conventional loans.²³ At first glance, the substitution of insured loans, such as FHA loans, for conventional loans may appear benign or even beneficial, since one might believe that FHA insurance is enabling people who could not otherwise afford conventional financing to receive loans and become homeowners.²⁴ While the occasional or moderate use of FHA mortgages might not be detrimental to property values in a neighborhood, the extensive use of FHA mortgages is a process that leads to the deterioration of some older neighborhoods. The reason for the deterioration is that the value of property is directly related to the availability and extent of mortgage financing, since the typical buyer can afford to pay for property only the amount he can borrow from a mortgage lender. The value of houses in an area receiving little conventional lending may therefore decrease to conform to FHA loan limits. Thus, a decision by lending institutions to shift from conventional to FHA lending may quickly and dramatically decrease property values.²⁵

Perhaps the most subtle method of redlining employed in California,

Hearings, supra note 7, June 23, 1975, at 11, 32-33, 37, 71. A study by the Center for New Corporate Priorities on mortgage lending practices in Southern California indicates that in the Los Angeles area, effectively one million people (or 14 percent of the population) reside in redlined areas. The residents of these redlined areas have seven million dollars on deposit and if the branch offices of savings and loans whose two-mile primary service area includes redlined areas are included, the deposit figure is one and a half billion dollars. Despite this economic power, these neighborhoods receive less than one percent of the single-family loans. *Redline Hearings, supra* note 7, June 16, 1975, no. 1, at 4.

20. *E.g.*, Roger Williams, representing Great Western Savings and Loan, testified, "[W]e do not under any circumstances set aside an area because of lending problems as an area in which we will not lend with the possible exception of very bad slide areas and very severe subsoil conditions." *Redline Hearings, supra* note 7, June 16, 1975, no. 2, at 7; Joe Angelo, Vice-President for Urban Affairs, Bank of America, testified, "If I understand the expression 'redlining' it simply means drawing a red line around a neighborhood and ruling it off limits for real estate loans. This is just not done by the Bank of America." *Redline Hearings, supra* note 7, June 27, 1975, no. 3, at 1.

21. *Redline Hearings, supra* note 7, Dec. 5, 1975, at 103-05.

22. *E.g.*, *Redline Hearings, supra* note 7, Dec. 12, 1975, at 41. One witness was told by a lender in Oakland, "We don't lend anywhere east of Fruitvale Ave." The ironic part of this situation was that while this property supposedly did not have any value to banks and savings and loans, in the new assessed valuation, this same property was re-evaluated at a \$2800 increase over the previous value. *Redline Hearings, supra* note 7, June 23, 1975, at 85.

23. *Redline Hearings, supra* note 7, June 16, 1975, no. 1, at 18.

24. *Id.* at 18-19.

25. *Id.* A study done by the Community Information Project of the Western Center on Law and Poverty indicates the effects of restricting an area to FHA insured loans. The study indicated that heavy redlining was occurring in the Pasadena-Alhambra area, which is not a "slummy community." These are homes that prior to redlining were selling for \$100,000 in many neighborhoods, but as soon as redlining began, the homes had their values artificially dropped down to ceilings in the \$40,000's. *Id.* at 17-18. One factor that may induce financial institutions to take such action is the heavy influx of minorities into the neighborhood which the institutions feel will cause an ultimate drop in property values.

however, is granting loans in redlined areas only on more onerous terms and conditions than those for loans in other areas. Testimony at the Redline Hearings indicated that loans are typically available in any part of the city, but the cost of the loans is variable.²⁶ Some of the tactics used by financial institutions in the course of this type of redlining include²⁷ requiring higher down payments than are usually required for financing comparable property,²⁸ charging higher interest rates,²⁹ fixing earlier maturity dates and thus making monthly payments higher, and fixing minimum amounts for loans and thereby excluding lower priced property. Other tactics include stalling on appraisals, setting appraisals below actual market value³⁰ and thereby requiring the borrower to come up with a higher down payment, applying more rigid appraisal standards, refusing to lend on the basis of "presumed economic obsolescence" regardless of the actual condition of the older property,³¹ and charging higher discount points on loans in redlined areas than charged for comparable property in other areas in order to discourage financing.³² These tactics have the effect of discouraging mortgage financing in redlined areas, or even of making mortgage financing unavailable as a practical matter, since residents of redlined areas are typically the least able to afford these increased costs.

While the essence of redlining is geographical discrimination in home loans, most definitions of redlining include two general categories.³³ Racial redlining refers to policies or practices by which lending institutions discriminate in the granting of, or in the setting of terms for, home loans based on the perceived racial characteristics, determined by present or projected occupants, of the neighborhood in which the borrower wishes to live. Economic redlining refers to policies and practices of lenders that consider certain geographical areas as zones of excessive risk, regardless of the characteristics of the individual borrower or the property involved.³⁴

26. *Redline Hearings*, *supra* note 7, June 23, 1975, at 37.

27. Comment, *Redlining: Potential Civil Rights and Sherman Act Violations Raised by Lending Policies*, 8 IND. L. REV. 1045, 1045 n.2 (1975).

28. Testimony at the hearings indicated that in the Mission District of San Francisco (a redlined area), the required down payments are as much as 20 percent higher than other areas of the city. *Redline Hearings*, *supra* note 7, June 23, 1975, at 38.

29. Testimony at the hearings indicated that in East Los Angeles (a redlined area), the interest rates ranged from 10 3/4 to 11 1/4 percent, as compared to 9 1/4 percent prevailing rate across the rest of the city. *Redline Hearings*, *supra* note 7, Dec. 5, 1975, at 45.

30. *Redline Hearings*, *supra* note 7, June 23, 1975, at 38.

31. Comment, *Redlining: Potential Civil Rights and Sherman Act Violations Raised by Lending Policies*, 8 IND. L. REV. 1045, 1045 n.2 (1975). The refusal to make loans on property older than a certain age is a form of redlining even though it differs in concept from more traditional redlining practices. This practice does not come within the traditional definition of redlining because ostensibly it is not directed at an entire neighborhood. The net effect, however, may be the same because the majority of homes may exceed the age classification, thus effectively depriving that area of any source of mortgage money. Renne, *Eliminating Redlining by Judicial Action: Are Erasers Available?*, 29 VAND. L. REV. 987, 990 (1976).

32. Testimony at the hearings indicated that in the Mission District of San Francisco (a redlined area) the borrower will probably pay three points as opposed to a point or a point and a half in Richmond. *Redline Hearings*, *supra* note 7, June 23, 1975, at 37-38.

33. Comment, *Urban Housing Finance and the Redlining Controversy*, 25 CLEV. ST. L. REV. 110, 110 n.1 (1976).

34. *Id.*

Although financial institutions assert that only economic redlining occurs in California,³⁵ studies done by consumer groups and by the California Department of Savings and Loan indicate that racial redlining does exist in California, in effect if not in intent.³⁶ Studies in Los Angeles indicate that all-white areas receive twice as much mortgage money per capita as integrated areas.³⁷ Lending ranged from a low of one dollar per capita in the hispanic neighborhoods to \$125 per capita in areas with populations less than five percent hispanic. Neighborhoods with less than a five percent black population received \$60 per person, while those with more than a 90 percent black population received less than two dollars per person.³⁸ Studies in San Francisco and Alameda County indicated much the same pattern with only minor variation.³⁹ Thus, it seems clear that California financial institutions do engage in the practice of racial redlining.

DISCLOSURE OF LENDING PRACTICES

Before the problem of redlining can be attacked effectively on a statewide basis, there must be disclosure by financial institutions to regulatory agencies and to the public of their actual lending practices.⁴⁰ Such disclosure is essential to determine the true dimension of the redlining problem in California. Public interest groups that have studied redlining practices assert that problems such as redlining would not be likely to occur if all citizens were completely informed of the institution's lending policies.⁴¹

Public disclosure of redlining practices would also have several other advantages.⁴² Disclosure would generate more widespread public interest in efforts to control redlining, and this increased public awareness might result in increased political pressure on the legislature and the regulatory agencies to apply sanctions against institutions which engage in redlining. The disclosed information on redlining practices would also provide plaintiffs alleging discrimination in home financing in violation of the civil rights statutes with sufficient evidence to establish a prima facie case of discrimination. Finally, local government officials, equipped with extensive infor-

35. *Redline Hearings*, *supra* note 7, June 16, 1975, no. 2, at 4; *Redline Hearings*, *supra* note 7, June 23, 1975, at 41-42.

36. *E.g.*, *Redline Hearings*, *supra* note 7, June 23, 1975, at 47, 53.

37. *Id.* at 53.

38. *Id.*

39. *Id.* at 47.

40. *E.g.*, *Redline Hearings*, *supra* note 7, June 16, 1975, no. 1, at 34; *Redline Hearings*, *supra* note 7, June 23, 1975, at 61, 80. There was evidence that even the simplest type of data can sometimes be difficult to get. One consumer organization had to sue the Federal Reserve Board and get a judgment before information would be disclosed on consumer interest rates for banks that are members of the Federal Reserve System - information which was public at the local level for other banks. *Redline Hearings*, *supra* note 7, June 23, 1975, at 79.

41. If the citizens were informed, they could use the economic power of their pocket-books and their votes to make desired changes. *Redline Hearings*, *supra* note 7, June 23, 1975, at 81.

42. Comment, *A Proposal for Eliminating Redlining: The Missouri Financial Institutions Disclosure Act of 1976*, 20 ST. LOUIS L.J. 722, 739 (1975).

mation on the lending activities of local financial institutions, could exert pressure on local lenders to invest in and help maintain city neighborhoods.⁴³ In the following section the extent to which the lending practices of financial institutions are currently being disclosed to the regulatory agencies in California will be examined, and needs for additional disclosure consistent with the right to privacy of the individual borrower will be determined.

A. Current Disclosure Requirements

Although the California Department of Savings and Loan currently collects more data on the mortgage lending practices of its associations than any other state or federal agency,⁴⁴ there was testimony at the Redline Hearings that this data is nevertheless insufficient to allow either the regulatory agencies⁴⁵ or the savings and loan institutions themselves⁴⁶ to determine whether redlining exists within the institutions.⁴⁷ The testimony indicated that this data has critical gaps, and more importantly, is not available to the public.⁴⁸

However, the Redline Hearings that were conducted by California's Business and Transportation Agency resulted in several measures to require further disclosure by financial institutions. Effective August 1, 1976, the Savings and Loan Commissioner adopted regulations requiring public disclosure of data on loans made after that date by all state-licensed savings and loan associations.⁴⁹ These regulations have been termed the most comprehensive provisions of their type by one California consumer group.⁵⁰

The regulations require that the data on the Commissioner's monthly loan register tapes, and copies of the tapes themselves, be made available to the public.⁵¹ The data on these tapes includes information filed by savings and loan associations on each real estate and home improvement loan made. Information is also reported on loans purchased and sold, and on loan applications denied. The data contained on the tapes relates to the characteristics of the loan, of the property, and of the individual applicant or applicants. The savings and loan making or denying the loan is identified.⁵² Even though these tapes must be made available to the public, certain information from the tape may be withheld if the Commissioner determines the withholding of such information would be necessary to protect the right

43. See *id.*

44. *Redline Hearings*, *supra* note 7, June 23, 1975, at 54.

45. *Redline Hearings*, *supra* note 7, Dec. 5, 1975, at 38.

46. *Redline Hearings*, *supra* note 7, June 27, 1975, no. 3, at 23.

47. In the late 1960's, there was a system run by the Savings and Loan Commissioner's office that provided every state savings and loan with a complete analysis of its lending program by census tract and by loan type and gave a comparison with the industry's totals for every census tract in the state. The system became too expensive to operate and was terminated in 1970. *Id.*

48. *Redline Hearings*, *supra* note 7, June 23, 1975, at 54.

49. 10 CAL. ADMIN. CODE §§242.2(t), 242.2(u), 245-246.7.

50. *Redline Hearings*, *supra* note 7, Dec. 5, 1975, at 14.

51. 10 CAL. ADMIN. CODE §242.2(t).

52. 10 CAL. ADMIN. CODE §242.2(t).

to privacy of the individual borrower or applicant.⁵³ The drafters of the regulations intended for this to be a very limited exception, however, and in most cases, all of the data contained on the tapes would be made available to the public.⁵⁴ In addition to requiring disclosure to the public, the regulations issued by the Savings and Loan Commissioner also require disclosure to the individual loan applicant of information that is designed to enable the applicant to determine whether he has been the victim of discriminatory lending practices.⁵⁵

The regulations also require the Savings and Loan Commissioner to publish Fair Lending Reports "from time to time and at least annually."⁵⁶ These Fair Lending Reports contain detailed breakdowns for each association of information contained on the monthly loan register reports, as well as an analysis by the Commissioner of lending patterns, and a summary of complaints filed with the Commissioner alleging violations of the subchapter of the regulations on fair lending.⁵⁷ These regulations apply only to state-chartered savings and loan associations, however, and thus do not require disclosure of the lending practices of banks or mortgage companies.⁵⁸

53. 10 CAL. ADMIN. CODE §242.2(t).

54. See *Redline Hearings*, *supra* note 7, Dec. 5, 1975, at 85-87.

55. 10 CAL. ADMIN. CODE §245.4. Testimony at the Redline Hearings emphasized that in dealing with borrowers in redlined areas, it is especially important to create an awareness on the part of the individual applicants that they have a right to challenge the financial institution's decision. Since borrowers in redlined areas are often the least able to understand how to borrow, they are easily discouraged when faced with the obstacle that the more educated or refined individual might be willing to fight. *Redline Hearings*, *supra* note 7, Dec. 5, 1975, at 66. The regulations themselves only require disclosure to the loan applicant by state-licensed savings and loan associations, 10 CAL. ADMIN. CODE §245.4, but a bill was introduced in the California Legislature on Dec. 6, 1976 that would require similar disclosure by banks, mortgage brokers, or any other institution that regularly makes mortgage loans. SB 3, 1977-78 Regular Session (proposed addition of §1788.01 *et seq.* to the Civil Code) (*as amended* Feb. 9, 1977).

56. 10 CAL. ADMIN. CODE §242.2(u).

57. 10 CAL. ADMIN. CODE §242.2(u).

58. 10 CAL. ADMIN. CODE §§242.2(t), (u), 245-246.7. A bill was introduced in the California Legislature on Dec. 6, 1976, SB 6, 1977-78 Regular Session, that would require banks to compile information related to housing loans and to forward that information to the Superintendent of Banks, SB 6, 1977-78 Regular Session (proposed addition of §1932(a) to the Financial Code) (*as amended* Mar. 3, 1977). (Even with SB 6, mortgage companies would apparently still be exempt from disclosure requirements). This information is also to be made available for public inspection at each office of the bank. The information required would be similar to that required by the existing regulations of the Savings and Loan Commissioner. 10 CAL. ADMIN. CODE §§242.2(t), (u), 245-246.7. SB 6 would also require public disclosure by savings and loan associations of their mortgage lending practices. SB 6, 1977-78 Regular Session (proposed addition of §§5253, 8707.3 to the Financial Code) (*as amended* Mar. 3, 1977). Thus, if SB 6 becomes law, it will supersede the Savings and Loan Commissioner's regulations on the same topic, since the Savings and Loan Commissioner is given authority to promulgate regulations not inconsistent with state law, CAL. FIN. CODE §5255, and SB 6 would be an inconsistent state law. Pursuant to the SB 6 provisions, the Savings and Loan Commissioner will be required to publish reports *quarterly* rather than "from time to time and at least annually." SB 6, 1977-78 Regular Session (proposed addition of §5253 to the Financial Code) (*as amended* Mar. 3, 1977); 10 CAL. ADMIN. CODE §242.2(u). This change would thus guarantee that the public has access to data on the lending practices of financial institutions on a timely basis.

SB 6, however, may make a more significant *undesirable* change in the form in which data is required to be disclosed to the public. Under the current regulations, the loan register tapes themselves may be copied and made available to the public for the cost of copying. 10 CAL. ADMIN. CODE §242.2(u). SB 6 would appear to require only the Commissioner's reports or

In addition to the savings and loan regulations currently requiring disclosure, provisions have been added to the Health and Safety Code to require the compilation of data which will assist in identifying redlining practices.⁵⁹ The main thrust of this legislation, known as the Zenovich-Moscone-Chacon Housing and Home Finance Act, is to create the California Housing Finance Agency.⁶⁰ This Act also makes the Department of Housing and Community Development responsible for developing a California Statewide Housing Plan.⁶¹ This Plan will contain an evaluation and summary of housing conditions throughout the state with particular emphasis on the availability of housing for all economic segments of the state.⁶² The Plan will also include an identification of market constraints and obstacles, and specific recommendations for their removal.⁶³ In this provision, the Department is thus given the responsibility for identifying areas where redlining is occurring and documenting these areas in the Statewide Housing Plan.⁶⁴ Once the Plan is developed, the Department of Housing and Community Development is directed to make "[s]ufficient copies . . . available for distribution to concerned persons throughout the state."⁶⁵ Thus, the Statewide Housing Plan will be another vehicle through which redlining practices of financial institutions will be disclosed to the public.

As the previous discussion indicates, California currently requires disclosure of data on mortgage lending practices by a number of state departments and agencies,⁶⁶ and bills which are currently in the legislature would require disclosure by a number of financial institutions and state agencies that are

copies of the reports to be made available to the public. SB 6, 1977-78 Regular Session (proposed addition of §8707.3 to the Financial Code) (*as amended* Mar. 3, 1977). For public interest groups planning to do studies based on this data, the difference could be critical, since information summarized in one manner is often impossible to summarize in a different manner. The information that the Savings and Loan Commissioner is required to disclose under SB 6 would appear to be in a highly summarized form. SB 6, 1977-78 Regular Session (proposed addition of §8707.3 to the Financial Code) (*as amended* Mar. 3, 1977). Thus, SB 6 might be a much more effective tool in the disclosure of redlining data if the loan register tapes themselves, in addition to the summarized reports, were made available to the public. Certain data could still be deleted from the tapes in the limited number of instances where deletion is necessary to protect the loan applicant's right to privacy.

59. CAL. HEALTH & SAFETY CODE §41000 *et seq.* (effective Sept. 26, 1975).

60. The Act also continued the existence of the California Department of Housing and Community Development. Otherwise, the Department would have been operative only until the 61st day after final adjournment of the 1976 Regular Session of the California Legislature. AB 1, 1st Extra. Session 1975-76, Legislative Counsel's Digest, at 2.

61. CAL. HEALTH & SAFETY CODE §41125.

62. CAL. HEALTH & SAFETY CODE §41126(a).

63. CAL. HEALTH & SAFETY CODE §41126(d).

64. The Plan should also contain recommendations for state and other public and private actions which will contribute to the attainment of housing goals established for California. CAL. HEALTH & SAFETY CODE §41126(f). The Plan will be revised annually and submitted to the legislature for adoption. CAL. HEALTH & SAFETY CODE §41127. The Department of Housing and Community Development is also directed to establish a statewide housing information system, CAL. HEALTH & SAFETY CODE §41132, and is given authority to provide a statistics and research service for the collection and dissemination of information affecting housing and community development. CAL. HEALTH & SAFETY CODE §41131.

65. CAL. HEALTH & SAFETY CODE §41129.

66. California financial institutions may also be subject to the disclosure requirements of the Federal Reserve System or the Federal Deposit Insurance Corporation which were effective March 25, 1977. L.A. Daily J., April 1, 1977, at 1, col. 4; at 2, col. 3.

not currently required to disclose data to the public. There is wide variation, however, in the types of data collected by the various agencies and in the form in which the data is disclosed to the public. Some agencies disclose data on a very detailed level,⁶⁷ while others disclose data in a summary form.⁶⁸ The sheer number of statutes and regulations requiring disclosure of various types of data will present an additional problem for the consumer or regulatory agency interested in obtaining data on statewide lending practices. The existing statutes and potential statutes requiring disclosure are scattered among the Health and Safety Code,⁶⁹ the Civil Code,⁷⁰ and the Financial Code,⁷¹ while the Savings and Loan Commissioner's regulations are contained in the Administrative Code.⁷² Thus, even though California has very extensive disclosure requirements for financial institutions, there may be some problem disseminating to consumers or regulatory agencies all of the information that is available, since the information is available from a number of diverse sources.

B. Recommendations on Disclosure of Lending Practices

In order for a truly comprehensive picture of mortgage lending practices to emerge, it would seem reasonable to require *all* data related to housing finance to be collected and disclosed to the public through one central source. Since the Department of Housing and Community Development is already authorized to provide a statistics and research service for collection and dissemination of housing information,⁷³ and since the Department is also directed to establish a statewide housing information system,⁷⁴ the Department would be the logical repository for such data. The data currently provided by banks and savings and loan associations to their regulatory agencies could be provided to the Department of Housing and Community Development as well.

The requirement of a central source for *all* data related to housing finance would have several advantages. First, data would be available to the public from a central source. Consumers interested in obtaining data on statewide lending practices would be more likely to become informed of all data that is available.⁷⁵ Second, having all data available at the Department of Housing and Community Development would provide the type of data base that

67. *E.g.*, Department of Savings and Loan, 10 CAL. ADMIN. CODE §242.2(t), (u).

68. *E.g.*, Department of Housing and Community Development, CAL. HEALTH & SAFETY CODE §41129.

69. *E.g.*, CAL. HEALTH & SAFETY CODE §41129.

70. SB 3, 1976-77 Regular Session (proposed addition of §1788.01 *et seq.* to the Civil Code) (as amended Feb. 9, 1977).

71. *E.g.*, SB 6, 1976-77 Regular Session (proposed addition of §1932 to the Financial Code) (as amended Mar. 3, 1977).

72. *E.g.*, 10 CAL. ADMIN. CODE §242.2(t), (u).

73. CAL. HEALTH & SAFETY CODE §41131.

74. CAL. HEALTH & SAFETY CODE §41132.

75. The logistics of traveling to the head office of every bank in the state or even the requirement of visiting many state agencies to compile statewide information on housing would discourage public involvement and would be unnecessarily time-consuming and expensive.

would enable the Department to compile a meaningful Statewide Housing Plan. Third, the collection of all data relating to housing finance at the Department would facilitate the development of regulations identifying priority areas for the Housing Finance Agency.⁷⁶ Fourth, reports provided to the public could be produced in one format rather than in the variety of formats that will result from disclosure by individual financial institutions. Last, numbering systems or coding systems would be uniform and data collected from diverse sources could be correlated readily. Thus, establishment of one central source for the collection and dissemination of data on lending practices of financial institutions would serve to streamline the disclosure process from a consumer standpoint and would serve to insure that the state agencies involved consider all relevant information when making decisions regarding housing finance.

LEGAL BASES FOR CHALLENGING REDLINING

Although a variety of legislation designed to control redlining practices has been introduced, there is currently no California statute that expressly makes redlining illegal. Moreover, existing California law would appear to directly sanction redlining, since Section 7176 of the Financial Code provides that the Savings and Loan Commissioner may "prohibit an association from making further loans within any geographic area where the making of future loans would constitute an unsound business practice."⁷⁷ Rather than sanctioning redlining, however, the Savings and Loan Commissioner has issued a comprehensive set of regulations representing the only California law directly addressing the problem of redlining and related discriminatory mortgage lending practices.⁷⁸

In addition to the regulations, the racial redlining practices of financial institutions may arguably be challenged under a number of state and federal

76. The Department of Housing and Community Development may propose regulations to be adopted by the Housing Finance Agency which designate geographical areas of need throughout the state for housing construction or rehabilitation as identified in the California Statewide Housing Plan. These regulations should identify housing markets in which insufficient financing is available for purchase or rehabilitation of existing housing. CAL. HEALTH & SAFETY CODE §41137(g). Regulations may also be proposed by the Housing Finance Agency in this area, but they will not take effect without concurrence of the Director of the Department of Housing and Community Development or the Secretary of the Business and Transportation Agency. CAL. HEALTH & SAFETY CODE §41137.

77. CAL. FIN. CODE §7176.

78. 10 CAL. ADMIN. CODE §§145.7, 147.6, 204.2(q), 242.2(t), (u), 245-246.7. These regulations, which went into effect on August 1, 1976, were issued pursuant to the general authority to promulgate rules and regulations which is vested in the Savings and Loan Commissioner by CAL. FIN. CODE §5255. As long as these regulations do not conflict with other statutory provisions, they will carry the force and effect of law. The only statute the regulations might possibly conflict with would be CAL. FIN. CODE §7176. However, §7176 merely *permits* the Savings and Loan Commissioner to authorize redlining if this is required by sound business practice rather than requiring redlining. Since the regulations themselves permit redlining if the association can demonstrate that it is necessary in a particular case to avoid an unsafe or unsound business practice, there would appear to be no conflict between the regulations and CAL. FIN. CODE §7176.

civil rights statutes.⁷⁹ In California, the Unruh Civil Rights Act⁸⁰ and the Rumford Fair Housing Act⁸¹ may be applicable to racial redlining. On the federal level, the Civil Rights Act of 1866,⁸² the Fair Housing Act of 1968,⁸³ and the Civil Rights Act of 1964⁸⁴ may provide bases for challenging redlining practices. Determining which of these statutes is applicable in a given situation may depend on the race of the borrower, the racial composition of the neighborhood in which redlining is alleged and the presence or absence of government insurance for the loan. There is also considerable overlap in applicability of the statutes, and the statute that is primarily relied on by the borrower in an individual situation may depend on the remedies available under each statute. This section will examine the applicability of the regulations and the civil rights statutes as legal grounds for challenging redlining practices.

A. The California Regulations

The administrative regulations promulgated by the Savings and Loan Commissioner are currently limited in their applicability to state-licensed savings and loan associations.⁸⁵ The state-licensed savings and loan associations that are subject to the regulations make approximately one-third of all mortgage loans made in California.⁸⁶ No similar regulations currently exist for other types of financial institutions, such as banks or mortgage companies.⁸⁷ The regulations are also limited to redlining which occurs in the consideration of loans for the purchase of one to four family properties by owner-occupants, and loans for refinancing with improvement.⁸⁸

1. Substance of the California Regulations

Even though the administrative regulations do not pertain to all financial institutions and to loans for all types of property, the regulations are

79. These statutes would also apply to the savings and loan associations that are covered by the administrative regulations since statutes take precedence over administrative regulations on the same topic. See, e.g., *Morris v. Williams*, 67 Cal. 2d 733, 433 P.2d 697, 63 Cal. Rptr. 689 (1967).

80. CAL. CIV. CODE §51.

81. CAL. HEALTH & SAFETY CODE §35700 *et seq.*

82. 42 U.S.C. §1982 (1970).

83. 42 U.S.C. §3601 *et seq.* (1970).

84. 42 U.S.C. §2000d *et seq.* (1970).

85. 10 CAL. ADMIN. CODE §245(c)(4).

86. *Redline Hearings*, *supra* note 7, Dec. 12, 1975, at 4.

87. There is a bill that was introduced on December 16, 1976, that would take the substance of these regulations, including the establishment of the boards of inquiry, and make them applicable to a wider range of financial institutions. The financial institutions that would be covered by the bill include any bank, savings and loan association, mortgage broker, or other institution in this state, including a state or local public agency, that regularly makes, arranges, or purchases loans for the purchase, construction, rehabilitation, improvement, or refinancing of housing accommodations, and includes the officers and agents of such institutions or agencies. AB 79, 1977-78 Regular Session) (as introduced Dec. 16, 1976).

88. 10 CAL. ADMIN. CODE §245.1(d), (f). However, the Commissioner has stated his intention to develop standards and guidelines necessary to expand the coverage of the regulations. Letter from Saul Perlis, Savings and Loan Commissioner, to all state-licensed savings and loan associations, July 2, 1976, at 4 (copy on file at the *Pacific Law Journal*).

comprehensive in scope, and they have served as a model for proposed legislation in this area.⁸⁹ In addition to requiring disclosure to individuals and to the public,⁹⁰ the regulations prohibit certain restrictive lending practices based on neighborhood factors⁹¹ and require affirmative action by the saving and loan associations in order to increase the extent of lending in redlined areas.⁹² The regulations also establish boards of inquiry to review individual complaints concerning redlining.⁹³

The major thrust of the regulations is contained in the subchapter on fair lending.⁹⁴ The purposes of this subchapter include prevention of discrimination in home lending because of the conditions, characteristics or trends in the neighborhood or geographical area surrounding the property, and inducement of more lending in areas and to groups that have previously been deprived of mortgage financing.⁹⁵ At the same time, however, the regulations add a major qualification to their proscription of redlining practices by requiring that the prevention be *consistent with sound business practice*.⁹⁶ This qualification, depending on its interpretation, may render the balance of the regulations virtually ineffective in controlling redlining practices. However, in discussing this qualification in the subchapter on fair lending, the Commissioner expressly declared that:

in determining whether and under what terms and conditions to make mortgage loans, associations have sometimes discriminated based on consideration of neighborhood factors in a manner not required as a matter of sound business practice⁹⁷

The Commissioner also stated that this discrimination has often been arbitrary, and has caused or contributed to the decline of available livable housing in the affected areas.⁹⁸ Furthermore, the Commissioner acknowledged that the practice of discriminating in mortgage lending on the basis of

89. Legislation modeled on the regulations include AB 79, SB 3, SB 6, SB 7, 1977-78 Regular Session.

90. 10 CAL. ADMIN. CODE §242.2(t), (u).

91. 10 CAL. ADMIN. CODE §245.2.

92. 10 CAL. ADMIN. CODE §§147.6, 245.5. Each association is also required to maintain on file with the Commissioner a document describing the marketing policies and programs of the association. In describing the elements of its marketing program, the association is directed to give special emphasis to the extent to which such information relates to affirmative programs by the association designed to market services, including the making of loans, to groups protected by the regulations and to residents and potential residents of various neighborhoods. 10 CAL. ADMIN. CODE §245.5. The regulations also provide that in reaching a decision on applications for new branch offices, the Commissioner may consider, among other things, the extent of compliance with the subchapter of the regulations on Fair Lending, the extent to which the association's present and anticipated marketing policies and programs affirmatively further the purposes of the subchapter on Fair Lending, and information on the association's affirmative action programs received pursuant to §147.5. Consideration of Fair Lending and Affirmative Action Programs will be given special emphasis when there are competing applications for a branch facility. 10 CAL. ADMIN. CODE §147.6(b).

93. 10 CAL. ADMIN. CODE §245.7.

94. 10 CAL. ADMIN. CODE, Subchapter 23 (commencing with §245).

95. 10 CAL. ADMIN. CODE §245(b).

96. 10 CAL. ADMIN. CODE §245(b). See text accompanying note 104 *infra*.

97. 10 CAL. ADMIN. CODE §245(c)(5).

98. 10 CAL. ADMIN. CODE §245(c)(5)(A), (B).

neighborhood factors has also had a sharp discriminatory effect against racial and ethnic minorities.⁹⁹

After acknowledging the history of redlining, the regulations then proceed to expressly prohibit redlining by providing that:

No association shall deny a mortgage loan, or discriminate in application procedures or in the setting of terms or conditions of any such loan, due, in whole or in part, to consideration of the conditions, characteristics or trends in the neighborhood or geographic area surrounding the security property, unless the association can demonstrate that such consideration in the particular case is required to avoid an unsafe or unsound business practice.¹⁰⁰

In an effort to keep the regulation's "unsafe or unsound business practice" exception from becoming an exception that swallows the rule, an entire subchapter was included in the regulations entitled "Guidelines Relating to Fair Lending."¹⁰¹ The guidelines emphasize that the strong intent of the regulations is that associations should be making every effort to find and to make the sound loans that can be made in historically redlined areas and that an association's compliance with the regulations will be reviewed in this light.¹⁰² The guidelines then set forth detailed examples of policies and practices that will be considered discriminatory in effect and unnecessary to achieve an overriding legitimate business purpose.¹⁰³

If the guidelines and the regulations are enforced in the same spirit of controlling redlining practices wherever possible in which they were enacted, they may represent a significant first step in making savings and loan associations accountable for discriminatory loan practices. The regulations, however, appear to allow the lender to apply inherently subjective criteria in determining whether the loan will be granted, such as "future market value" of the property.¹⁰⁴ The use of such subjective criteria to justify denial of a loan could defeat the entire purpose of the regulations, since it is very difficult to prove the reasonableness of subjective value judgments. If an association can document that the fair market value of the property is likely to decrease during the early years of the mortgage term, then the association may deny the loan or may make an adjustment in the loan to value ratio,¹⁰⁵ thereby increasing the down payment required by the borrower. The association may also require that a shorter term to maturity be used,¹⁰⁶ thereby increasing the borrower's monthly payment. Under the guidelines, then, documentation of decreasing fair market value, real or

99. 10 CAL. ADMIN. CODE §245(c)(6).

100. 10 CAL. ADMIN. CODE §245.2(a).

101. 10 CAL. ADMIN. CODE, Subchapter 24 (commencing with §246).

102. 10 CAL. ADMIN. CODE §246.1(b)(5).

103. 10 CAL. ADMIN. CODE §246.1(a).

104. 10 CAL. ADMIN. CODE §245.3(b).

105. 10 CAL. ADMIN. CODE §245.3(b)(1).

106. 10 CAL. ADMIN. CODE §245.3(b)(2).

alleged, would allow the savings and loan association to redline with impunity. The real danger with allowing the association to use future fair market value to justify refusal to make a loan is that the financial institution's decision is likely to become a self-fulfilling prophecy.¹⁰⁷ When the financial institution decides that an area is declining, no money is available in that area for maintaining or improving property, and the future decline of the area becomes inevitable.

2. Enforcement of the California Regulations

The initial interpretation of the extent to which the regulations may be used to control redlining practices will be the responsibility of the two boards of inquiry that were created by the regulations.¹⁰⁸ The boards will review complaints of alleged regulatory violations which the Savings and Loan Commissioner fails to resolve in 21 days.¹⁰⁹ With respect to each complaint reviewed, the board will make a finding of fact regarding whether there has been discrimination in mortgage lending, or redlining, in violation of the regulations or applicable provisions of law. All regulatory violations will be reported to the Secretary of the Business and Transportation Agency, with a copy of the report to the Savings and Loan Commissioner, for such action as the Agency Secretary deems appropriate.¹¹⁰ Under Section 9000 of the Financial Code, the Secretary could order an association to make a loan, since Section 9000, when read in conjunction with other statutes, gives the Secretary authority to "direct a discontinuance of such violations or unsafe or injurious practices and a conformity with all the requirements of law."¹¹¹

B. Statutory Control of Redlining Practices

For loans made by financial institutions other than state-chartered savings

107. *Redline Hearings*, *supra* note 7, June 16, 1975, no. 1, at 5.

108. 10 CAL. ADMIN. CODE §245.7(a). The boards of inquiry are established in the City of Los Angeles and the City and County of San Francisco, and in such other locations as the Secretary of the Business and Transportation Agency may designate. *Id.* Each board of inquiry will be composed of a public member, a representative of the savings and loan industry, and an employee of the Business and Transportation Agency or one of the departments within the Agency. 10 CAL. ADMIN. CODE §245.7(c).

109. 10 CAL. ADMIN. CODE §245.7(b).

110. 10 CAL. ADMIN. CODE §245.7(i).

111. CAL. FIN. CODE §9000. Section 9000 actually gives the *Savings and Loan Commissioner* authority to require the association to make the loan, but under CAL. GOV'T CODE §13978, the Secretary of the Business and Transportation Agency may exercise any power vested in any department within the Agency. A bill was introduced in the California Legislature on Dec. 6, 1976, that would expand the enforcement powers of the boards of inquiry. SB 7, 1977-78 Regular Session (proposed addition of §35800 *et seq.* to the Health and Safety Code) (*as amended* Feb. 9, 1977). Under the provisions of SB 7, the boards of inquiry would be given the same enforcement powers that the Agency Secretary has under the regulations. SB 7, 1977-78 Regular Session (proposed addition of §35834 to the Health and Safety Code) (*as amended* Feb. 9, 1977). In addition, if the board finds a pattern of discrimination, it may: (1) recommend that the State Treasurer disqualify the institution from receiving deposits of state funds; (2) recommend to regulatory agencies that affirmative marketing or lending programs be established; or (3) recommend to appropriate government agencies that the institution's loans not be eligible for purchase or insurance. SB 7, 1977-78 Regular Session (proposed addition of §35836 to the Health and Safety Code) (*as amended* Feb. 9, 1977). SB 7 would thus considerably expand the sanctions that may be taken against an institution that engages in redlining practices.

and loans,¹¹² there is no state law specifically addressing redlining practices. However, California's Unruh Civil Rights Act¹¹³ and Rumford Fair Housing Act¹¹⁴ prohibit discrimination in housing, and these statutes may be applied to redlining practices under certain circumstances. Federal laws, including the Civil Rights Act of 1866,¹¹⁵ the Fair Housing Act of 1968,¹¹⁶ and the Civil Rights of 1964,¹¹⁷ have also been applied to discrimination in housing. These federal and state laws may provide the basis for successfully challenging redlining practices by any financial institution, even those that are also subject to the regulations of the Savings and Loan Commissioner.¹¹⁸

Since the aforementioned statutes prohibit discrimination based on race, an initial inquiry relevant to the statutes' applicability to redlining would be whether the discrimination prohibited must be discrimination based on an *intentional* consideration of race as a factor, or whether a practice which *results* in discrimination based on race will constitute a violation of one of these statutes. This inquiry is relevant since it will determine the type of evidence that must be produced by a borrower in a redlined area to establish that the statute has been violated.

Concerning the federal statutes, *Shannon v. United States Department of Housing and Urban Development*¹¹⁹ examined the changes in the plaintiff's burden of proof in cases alleging discrimination in housing.¹²⁰ By 1974, it was well established by the federal circuit courts that the burden of proof in housing discrimination cases is governed by the concept of the "prima facie case."¹²¹ In order to establish a prima facie case of racial discrimination, the plaintiff need prove no more than that the conduct of the defendant actually or predictably results in racial discrimination: in other words, that it has a racially discriminatory effect.¹²² The plaintiff need make no showing whatsoever that the action resulting in racial discrimination was racially motivated. Effect, and not purpose, is the touchstone.¹²³ Once the plaintiff has established a prima facie case by demonstrating racially dis-

112. "Other financial institutions" are primarily banks and mortgage companies.

113. CAL. CIV. CODE §51.

114. CAL. HEALTH & SAFETY CODE §35700 *et seq.*

115. 42 U.S.C. §1982 (1970).

116. 42 U.S.C. §3601 *et seq.* (1970).

117. 42 U.S.C. §2000d *et seq.* (1970).

118. See note 79 *supra*.

119. 436 F.2d 809 (3d Cir. 1970).

120. *Id.* at 816-21.

121. *United States v. City of Black Jack*, 508 F.2d 1179 (8th Cir. 1974), *cert. denied*, 422 U.S. 1042 (1975), *rehearing denied*, 423 U.S. 884 (1975) (action brought under 42 U.S.C. §3601 *et seq.*). See also *Williams v. Matthews Co.*, 499 F.2d 819 (8th Cir. 1974), *cert. denied*, 419 U.S. 1021, 419 U.S. 1027 (1974) (action brought under 42 U.S.C. §§1981, 1982, and 42 U.S.C. §3604); *United Farmworkers of Fla. Hous. Project, Inc. v. City of Delray Beach*, 493 F.2d 799 (5th Cir. 1974) (action brought under 42 U.S.C. §§1981, 1982, 1983 and 42 U.S.C. §3604); *Barrick Realty, Inc. v. City of Gary*, 491 F.2d 161 (7th Cir. 1974) (action brought under 42 U.S.C. §3604); *United States v. Pelzer Realty Co., Inc.*, 484 F.2d 438 (5th Cir. 1973), *cert. denied*, 416 U.S. 936 (1974) (action brought under 42 U.S.C. §3601 *et seq.*); *Shannon v. HUD*, 436 F.2d 809 (3d Cir. 1970) (action brought under 42 U.S.C. §2000d and 42 U.S.C. §3601 *et seq.*).

122. *United States v. City of Black Jack*, 508 F.2d 1179, 1184 (8th Cir. 1974).

123. *Id.* at 1185.

criminatory effect, the burden shifts to the defendant to demonstrate that its conduct was necessary to promote some compelling interest.¹²⁴

The continued viability of this concept of the plaintiff's burden of proof of racially discriminatory effect was put somewhat in question when the United States Supreme Court decided the employment discrimination case of *Washington v. Davis*¹²⁵ in 1976. In that case, the testing procedures of a police department were challenged under the due process clause of the fifth amendment and under the Civil Rights Act of 1866.¹²⁶ The *Washington* Court held that a mere showing that the defendant's actions had a racially discriminatory *impact* was not sufficient, in and of itself, to establish a racially discriminatory *purpose*.¹²⁷ The *Washington* opinion thus makes it clear that racial impact is to be considered only as one factor in determining whether there was a racially discriminatory purpose.

However, the *Washington* opinion dealt primarily with a challenge to the validity of the employment test under the due process clause of the fifth amendment. The Court held that racially differential impact was not the *constitutional* standard for adjudicating claims of racial discrimination.¹²⁸ Thus, *Washington* may not affect the type of evidence that will be sufficient to establish a *prima facie* case in an action brought under a federal statute.¹²⁹

Washington was also an employment discrimination case, and it was distinguished in *Resident Advisory Board v. Rizzo*,¹³⁰ a later district court case involving discrimination in housing. In *Rizzo*, the court emphasized that prior to *Washington*, it was well established that proof of racial impact was all that was necessary to establish a *prima facie* case of discrimination in housing cases.¹³¹ The *Rizzo* court relied on the legislative history and remedial purpose of the Fair Housing Act of 1968 in concluding that proof of racial impact should be sufficient.¹³²

Following the reasoning of *Rizzo*, it may be argued that proof of racial impact should be sufficient to establish a *prima facie* case of violation of *any*

124. *Id.*

125. 426 U.S. 229 (1976).

126. *Id.* at 233. 42 U.S.C. §1981 (1970).

127. 426 U.S. at 239. In rejecting the adequacy of discriminatory impact alone to establish a *prima facie* case of discrimination, the Court did state that disproportionate racial impact is *relevant* to prove a discriminatory purpose since discriminatory purpose can often be inferred from the totality of the relevant facts. *Id.* at 241-42. Mr. Justice Stevens, in his concurring opinion, stated that frequently the most probative evidence of intent will be objective evidence of what actually happened rather than evidence describing the subjective state of mind of the actor, since normally the actor will be presumed to have intended the natural consequences of his acts. *Id.* at 253.

128. *Id.* at 239.

129. The Court did state, "We have never held that the constitutional standard for adjudicating claims of invidious racial discrimination is identical to the standards applicable under Title VII [of the Civil Rights Act of 1964], and we decline to do so today." *Id.* The fact that the Court did not discuss the standard that was applicable under the federal statute would indicate that they intended to leave the previously existing standard in that area undisturbed.

130. No. 71-1575 (E.D. Pa. Nov. 5, 1976).

131. *Id.*

132. *Id.*

of the *federal or state* civil rights statutes. The legislative history of the federal Fair Housing Act of 1968 provides the primary reason for requiring the plaintiff in a redlining action to prove only racial impact rather than racial purpose.¹³³ If residents of a redlined area are predominantly minority group members, a policy of denying mortgage money to that area will have the same effect of discriminating against those individuals as would a refusal to lend based on their race or color.¹³⁴ Since the prevention of discrimination of this type was one of the primary reasons for enacting a civil rights statute governing housing discrimination,¹³⁵ it may be argued that the plaintiff in any redlining action, state or federal, should be given the benefit of proving only discriminatory impact rather than purpose, and thereby shifting the burden of proof to the defendant after a *prima facie* case of discriminatory impact has been shown. In the following sections, each of the state and federal civil rights statutes will be examined to determine what other proof a plaintiff challenging redlining practices must offer to establish a violation of the statutes.

1. California Statutes

There is no California statute that expressly prohibits discrimination based on the geographical location of the property offered as security for a mortgage loan, although there are several bills in the current session of the legislature that will do so if passed.¹³⁶ However, if redlining practices by financial institutions are the equivalent of discrimination based on sex, race, color, religion, ancestry or national origin, then these redlining practices may be challenged under either the Unruh Civil Rights Act¹³⁷ or the Rumford Fair Housing Act.¹³⁸

In order to bring redlining practices within the scope of one of these statutes, the plaintiff would have to show that the neighborhood being redlined is composed primarily of persons in one of the groups that are protected by the statutes. Typically, a neighborhood being redlined will be composed of members of a racial minority, such as blacks. Consequently, minority group members are the ones primarily affected by the discrimination, and discrimination based on the location of the property becomes the functional equivalent of discrimination against members of a protected group. Redlining practices could thus arguably be challenged under either the Unruh Civil Rights Act or the Rumford Fair Housing Act.

133. *Id.*

134. Comment, *The Legality of Redlining Under the Civil Rights Laws*, 25 AM. U.L. REV. 463, 476 (1976).

135. Fair Housing Act of 1968, 42 U.S.C. §3601 *et seq.* (1970).

136. *E.g.*, SB 7 (as amended Feb. 9, 1977), AB 79 (as introduced Dec. 16, 1976), 1977-78 Regular Session.

137. CAL. CIV. CODE §51.

138. CAL. HEALTH & SAFETY CODE §35700 *et seq.*

a. *Unruh Civil Rights Act*

California's Unruh Civil Rights Act provides that:

all persons . . . no matter what their sex, race, color, religion, ancestry or national origin are entitled to the full and equal accommodations, advantages, facilities, privileges *or services* in all business establishments of every kind whatsoever.¹³⁹

In *Holmes v. Bank of America*,¹⁴⁰ Bank of America's refusal to grant a loan solely on the basis of the applicant's race was challenged under the Unruh Civil Rights Act. Bank of America argued that the Unruh Act does not require a national bank to lend its money on a non-discriminatory basis; that "no one has a right granted by law or otherwise to demand that a bank grant him a loan; [and] that a bank may refuse, in its own discretion, to make a loan for any reason or for no reason at all"¹⁴¹ The Bank also argued that even though the Unruh Act applies to "all business establishments of every kind whatsoever," the legislature did not intend for the Act to apply to every type of business *transaction* whatsoever, since only certain types of transactions are listed in the Act itself.¹⁴² The Bank further argued that since a loan is a contract, and since no person has a right to compel another to enter into a contract with him without the other's consent, the loan transaction falls within the express legislative exception to the Unruh Act.¹⁴³

The court in *Holmes* did not directly address the validity of the Bank's argument, since the lower court's decision was reversed on other grounds.¹⁴⁴ It would seem, however, that the Bank's argument that no one can be compelled to enter into a contract against his will would apply equally to the case of a restaurant or motel owner refusing service solely on the basis of the patron's race, and yet this is precisely the type of discrimination the Unruh Act was designed to proscribe. The fact that a bank could refuse to make a loan "for any reason or for no reason at all" prior to enactment of the Unruh Act does not mean that they may continue to do so in spite of the Unruh Act. The legislature's use of general language such as "privileges or services" rather than enumeration of a more specific list of business transactions would seem to indicate that the Unruh Act was intended to apply to a broad range of business transactions. It would also seem that if the legislature had intended to except such an important group of transactions as "all financial transactions" or "all contracts" from the Unruh Act, then the legislature would have been more explicit in doing so.

139. CAL. CIV. CODE §51 (emphasis added).

140. 216 Cal. App. 2d 529, 30 Cal. Rptr. 917 (1963).

141. *Id.* at 535, 30 Cal. Rptr. at 921.

142. *Id.*

143. *Id.* The exception to the Unruh Act provides, "This section shall not be construed to confer any right or privilege on a person which is conditioned or limited by law" CAL. CIV. CODE §51.

144. 216 Cal. App. 2d at 535-36, 30 Cal. Rptr. at 921.

Thus, it is arguable that a financial institution conducting a lending business is a "business establishment" engaged in providing "services" within the meaning of the Unruh Civil Rights Act.

In order to challenge the redlining practices of a financial institution under the Unruh Act, a plaintiff must first show that the neighborhood being redlined is composed primarily of members of a group protected by the Act, such as blacks. Since minority group members are the ones primarily affected by the redlining practices of financial institutions, the discrimination based on the location of the property becomes the functional equivalent of discrimination based on race. Thus, since blacks would not be obtaining "full and equal . . . services" in a "business establishment,"¹⁴⁵ the Unruh Civil Rights Act could be used to challenge the redlining practices of financial institutions.

b. Rumford Fair Housing Act

The Rumford Fair Housing Act¹⁴⁶ declares that discrimination in housing accommodations in California is against public policy. The Rumford Act also specifically states that it is unlawful for a financial institution to discriminate in the terms, conditions or privileges related to obtaining financial assistance because of the race, color, religion, sex, marital status, national origin, or ancestry of the borrower or of prospective occupants and tenants.¹⁴⁷ The Fair Employment Practices Commission is given authority to enforce the provisions of the Act.¹⁴⁸ If the Commission finds there has been a violation of the Rumford Act, it has the power to issue orders requiring respondent to cease and desist from such practices.¹⁴⁹

The Rumford Fair Housing Act would appear to cover racial redlining since racial redlining is discrimination based on the perceived racial characteristics, determined by present or projected occupants, of the neighborhood in which the borrower wishes to live.¹⁵⁰ The Rumford Act specifically prohibits discrimination because of the race of the borrower or of the prospective occupants or tenants of the property.¹⁵¹ The term "property" would probably be broadly construed to encompass residents of the neighborhood surrounding the security property rather than only residents of the security property itself. Borrowers who feel they have been the victims of racial redlining could thus file complaints with the Fair Employment Practices Commission. The Commission would appear to have the authority to

145. CAL. CIV. CODE §51.

146. CAL. HEALTH & SAFETY CODE §35700 *et seq.*

147. CAL. HEALTH & SAFETY CODE §35720(7).

148. CAL. HEALTH & SAFETY CODE §35730.5.

149. CAL. HEALTH & SAFETY CODE §35738.

150. Comment, *Urban Housing Finance and the Redlining Controversy*, 25 CLEV. ST. L. REV. 110, 110 n.1 (1976).

151. CAL. HEALTH & SAFETY CODE §35720(7).

require the financial institution to make the loan if this were the only way the financial institution could "cease and desist" from the injurious practice.

2. Federal Civil Rights Statutes

There is no federal statute that expressly prohibits discrimination based on the geographical location of the property offered as security for a mortgage loan. However, there are a number of federal statutes prohibiting discrimination on the basis of race, including the Civil Rights Act of 1866,¹⁵² the Fair Housing Act of 1968,¹⁵³ and the Civil Rights Act of 1964.¹⁵⁴ Since racial redlining is discrimination against the residents of an entire neighborhood on the basis of the racial composition of the neighborhood, these statutes arguably may be used to control racial redlining practices. The provisions of each of the aforementioned federal statutes will be examined to determine the circumstances under which each would be useful in controlling redlining practices.

a. Civil Rights Act of 1866

In 1866 Congress appointed a "Joint Committee of Fifteen" to determine if blacks in southern states continued to be victims of discrimination after the Civil War.¹⁵⁵ The Committee concluded that although statutory discrimination was almost eliminated, the prejudices of private persons remained intact.¹⁵⁶ To abolish the effects of this private prejudice, Congress enacted the Civil Rights Act of 1866.¹⁵⁷ Section 1982 of the Act provides:

All citizens of the United States shall have the same right, in every State and Territory, as is enjoyed by white citizens thereof to inherit, purchase, lease, sell, hold and convey real and personal property.¹⁵⁸

Although this language was available for many decades, it did not render its fullest protection to minority citizens until 1968 when the Supreme Court decided *Jones v. Alfred H. Mayer Co.*¹⁵⁹ In that case the Supreme Court held that Section 1982 reached beyond state action to operate on unofficial acts of private individuals.¹⁶⁰ The Court reasoned that since Section 1982 was derived from the thirteenth amendment, it was aimed at eliminating private as well as state discrimination.¹⁶¹ This interpretation of Section 1982

152. 42 U.S.C. §1982 (1970).

153. 42 U.S.C. §3601 *et seq.* (1970).

154. 42 U.S.C. §2000d *et seq.* (1970).

155. Comment, *Redlining: Remedies for Victims of Urban Disinvestment*, 5 FORDHAM URB. L.J. 83, 84 (1976).

156. *Id.*

157. *Id.*

158. 42 U.S.C. §1982 (1970).

159. 392 U.S. 409 (1968).

160. *Id.* at 413.

161. *Id.* at 422-37.

was reiterated by the Supreme Court in the 1972 case of *District of Columbia v. Carter*.¹⁶²

The Court in *Jones* made it clear, however, that they did not consider Section 1982 to be a comprehensive open housing law.¹⁶³ The Court said that unlike the Fair Housing Act of 1968, Section 1982 does not refer explicitly to discrimination in financing arrangements or in the provision of brokerage services.¹⁶⁴ Yet in 1973 a federal circuit court held in *Baker v. F & F Investment Co.*¹⁶⁵ that a cause of action was stated under Section 1982 against the Federal Housing Administration (FHA) and the Veterans Administration (VA) for alleged discriminatory market policies in the administration of their home loan mortgage insurance programs.¹⁶⁶ Thus, Section 1982 may be applicable to discrimination in financing arrangements despite the court's language to the contrary in *Jones*.

Section 1982 may be useful to California plaintiffs challenging redlining practices under roughly the same circumstances under which the Unruh Civil Rights Act may be used.¹⁶⁷ Under the Unruh Civil Rights Act, the plaintiff is entitled to damages of up to three times the amount of actual damage, but in no case less than \$250, plus attorneys fees,¹⁶⁸ while Section 1982 does not provide for an award in addition to actual damages. Thus, in a particular case, a plaintiff may be better off financially bringing a claim under the Unruh Civil Rights Act rather than Section 1982. In view of the more specific language of the Fair Housing Act of 1968 and the Rumford Fair Housing Act, however, it would be unusual for a plaintiff in a redlining action to rely solely on the Unruh Civil Rights Act or Section 1982.¹⁶⁹

b. Fair Housing Act of 1968

The federal Fair Housing Act of 1968 has the broad purpose of providing comprehensive prohibitions against all forms of housing discrimination,¹⁷⁰ and thus would appear to encompass redlining.¹⁷¹ Discrimination in the sale

162. 409 U.S. 418 (1973).

163. 392 U.S. 409, 413 (1968).

164. *Id.*

165. 489 F.2d 829 (7th Cir. 1973).

166. *Id.* at 831-32.

167. See text accompanying notes 139-145 *supra*. Section 1982 is much broader in scope than the Unruh Civil Rights Act, since the Unruh Act is limited to prohibiting discrimination by business establishments only, CAL. CIV. CODE §51, but in the redlining context, the discrimination is being done by financial institutions which are business establishments, so the difference is not likely to be important.

168. CAL. CIV. CODE §52.

169. Renne, *Eliminating Redlining by Judicial Action: Are Erasers Available?*, 29 VAND. L. REV. 987, 999 (1976).

170. See *Marr v. Rife*, 503 F.2d 735, 740 (6th Cir. 1974).

171. Neither the term "redlining" nor the phenomenon for which it stands appears in the Fair Housing Act itself, nor was the practice directly confronted during the legislative development of the Act. Comment, *Urban Housing Finance and the Redlining Controversy*, 25 CLEV. ST. L. REV. 110, 129 (1976). After an extensive examination of the legislative history, however, the brief for the United States in *Laufman v. Oakley Bldg. & Loan Co.*, 408 F. Supp. 489 (S.D. Ohio 1976), concluded, "While the legislative history does not specifically address the practice of redlining by name or direct description, it does reflect an emphatic Congressional rejection

or rental of housing and discrimination in the financing of housing are prohibited by Sections 3604 and 3605, respectively, of the Fair Housing Act.¹⁷² These sections would afford the logical basis for a suit challenging redlining practices.¹⁷³

Section 3604 expressly provides that it shall be unlawful to refuse to sell or rent, *or otherwise make unavailable or deny*, a dwelling to a person because of race, color, religion, sex, or national origin.¹⁷⁴ In *Laufman v. Oakley Building and Loan Co.*,¹⁷⁵ the court stated that with the current high cost of housing, a denial of financial assistance in connection with a sale of a home would effectively "make unavailable or deny" a "dwelling."¹⁷⁶ When the denial occurs as a result of racial considerations, Section 3604 is transgressed.¹⁷⁷

The language of Section 3605 is broader than the language of Section 3604. Section 3605 makes it unlawful for any financial institution¹⁷⁸ to deny or discriminate in setting the terms and conditions of a loan for the purpose of purchasing, constructing, improving, repairing, or maintaining a dwelling.¹⁷⁹ The court in *Laufman* found that the practice of redlining was prohibited by Section 3605 where the purpose of the loan was to finance the purchase of a home in an integrated neighborhood.¹⁸⁰ Even though it is a lower court opinion, the *Laufman* decision is significant because it is the first case that expressly held that the practice of racial redlining was prohibited by the civil rights laws.

The Fair Housing Act of 1968 may be used by California plaintiffs challenging the redlining practices of financial institutions. Although the language of the Fair Housing Act of 1968 is very similar to that of the Rumford Fair Housing Act, it may be advantageous for the California plaintiff to bring an action under the federal statute rather than filing a complaint with the Fair Employment Practices Commission. The federal court in *Laufman* has shown a willingness to declare redlining practices unlawful, whereas the Fair Employment Practices Commission might be reluctant to issue a cease and desist order requiring a financial institution to make a loan that the institution does not want to make. Thus the Fair Housing Act of 1968 might be more protective as a practical matter.

of the premise on which the practice is based." Comment, *Urban Housing Finance and the Redlining Controversy*, 25 CLEV. ST. L. REV. 110, 129 (1976).

172. 42 U.S.C. §§3604, 3605 (1970).

173. Comment, *The Legality of Redlining Under the Civil Rights Laws*, 25 AM. U.L. REV. 463, 475 (1976).

174. 42 U.S.C. §3604(a) (1970).

175. 408 F.Supp. 489 (S.D. Ohio 1976).

176. *Id.* at 493.

177. *Id.*

178. "Financial institution" is defined as "any bank, building and loan association, insurance company or other corporation, association, firm or enterprise whose business consists in whole or in part of the making of commercial real estate loans." 42 U.S.C. §3605 (1970).

179. 42 U.S.C. §3605 (1970).

180. 408 F.Supp. 489, 493 (S.D. Ohio 1976).

c. *Civil Rights Act of 1964*

Section 2000d of the Civil Rights Act of 1964 provides that:

No person in the United States shall, on the ground of race, color, or national origin, be excluded from participation in, be denied the benefits of, or be subjected to discrimination under any program or activity receiving Federal financial assistance.¹⁸¹

State financial institutions may receive federal financial assistance from deposit insurance provided by the Federal Deposit Insurance Corporation (FDIC),¹⁸² from eligibility for loans and advances due to membership in the Federal Reserve System,¹⁸³ or from guarantees received from the Federal Housing Administration (FHA),¹⁸⁴ or the Veterans Administration (VA).¹⁸⁵ It would appear, however, that Congress specifically excepted these types of federal financial assistance from the coverage of Section 2000d by the enactment of Section 2000d-1 which provides:

Each Federal department and agency which is empowered to extend Federal financial assistance to any program or activity, by way of grant, loan, or contract *other than a contract of insurance or guarantee* is authorized and directed to effect the provisions of 2000d¹⁸⁶

The language excluding contracts or guarantees would seem to indicate that programs or activities which receive federal financial assistance in the form of insurance or guarantees would be able to discriminate with impunity as far as the Civil Rights Act of 1964 is concerned, while programs or activities which receive federal financial assistance in other forms would be subject to the proscriptions of Section 2000d. However, in the *Laufman* case, the court held that 2000d and 2000d-1 did prohibit discrimination by a federally-chartered savings and loan association.¹⁸⁷ Since Oakley was a federally-chartered association, this may be distinguishable from the case of a state-chartered institution receiving only insurance or guarantees from FDIC, FHA, or VA. However, state-chartered financial institutions which are members of the Federal Reserve System might arguably come within the prohibitions of Section 2000d, since their membership in the Federal Reserve System makes them eligible for loans or advances of federal funds.¹⁸⁸ Thus, the redlining practices of state-chartered financial institutions which are members of the Federal Reserve System could arguably be challenged

181. 42 U.S.C. §2000d (1970).

182. 12 U.S.C. §§1815, 1816 (1964), §1821 (Supp. 1975).

183. 12 U.S.C. §§321, 347 (Supp. 1975).

184. 12 U.S.C. §1703 (Supp. 1975).

185. 38 U.S.C. §1815 (Supp. 1975).

186. 42 U.S.C. §2000d-1 (1970) (emphasis added).

187. 408 F.Supp. 489, 498-99 (S.D. Ohio 1976). In the course of its opinion the court stated that "[c]learly, Oakley Building and Loan Company is subject to the prohibitions of . . . §2000d-1," without really discussing the exception. *Id.* at 498.

188. 12 U.S.C. §347 (Supp. 1975).

under Section 2000d of the Civil Rights Act of 1964. State financial institutions which are not members of the Federal Reserve System but which receive insurance or guarantees from FDIC, FHA, or VA would appear to come within the exception stated in Section 2000d-1 and thus the redlining practices of these institutions could not be challenged under Section 2000d of the Civil Rights Act of 1964.

DEFENSE OF BUSINESS NECESSITY

Even though redlining may be challenged as a violation of the regulations promulgated by the Savings and Loan Commissioner,¹⁸⁹ or as a violation of state¹⁹⁰ or federal civil rights statutes,¹⁹¹ a financial institution which can establish the affirmative defense of "business necessity" may still be justified in continuing the practice.¹⁹² The rationale of the business necessity defense is that a practice or policy that is absolutely vital to the proper functioning of the enterprise may be sustained even in the face of its discriminatory effect.¹⁹³ The real extent to which redlining practices can be controlled in California thus depends on the extent to which business necessity justifies redlining practices. California has previously recognized the business necessity defense.¹⁹⁴ The guidelines in the regulations issued by the Savings and Loan Commissioner, for example, state that no association shall engage in a policy or practice which has the effect of discriminating against a protected group¹⁹⁵ "unless the association can demonstrate that [the] policy or practice is required to achieve an overriding legitimate business purpose."¹⁹⁶ The guidelines to interpretation of this section provide that if a practice clearly has the effect of discriminating against a protected group, the burden shifts to the association to demonstrate that the practice is required to achieve an overriding legitimate business purpose.¹⁹⁷ In determining whether such business purpose exists, the regulations adopt the same criteria for establishing business necessity that have been used by the federal courts in housing and employment discrimination cases.¹⁹⁸ These criteria are:

- (1) The business purpose must be an important business pur-

189. See text accompanying notes 85-111 *supra*.

190. See text accompanying notes 136-151 *supra*.

191. See text accompanying notes 152-188 *supra*.

192. See *Griggs v. Duke Power Co.*, 401 U.S. 424 (1971); *Williams v. Matthews Co.*, 499 F.2d 819 (8th Cir. 1974), *cert. denied*, 419 U.S. 1021 (1974).

193. Comment, *The Legality of Redlining Under the Civil Rights Laws*, 25 AM. U.L. REV. 463, 478 (1976).

194. *E.g.*, 10 CAL. ADMIN. CODE §246.3(a)(2).

195. "Protected group" in this context includes those who are discriminated against because of race, color, religion, sex, marital status, national origin or ancestry. 10 CAL. ADMIN. CODE §246.3(a) (1).

196. 10 CAL. ADMIN. CODE §245.2(c).

197. 10 CAL. ADMIN. CODE §246.3(a)(2).

198. *E.g.*, *Griggs v. Duke Power Co.*, 401 U.S. 424 (1971); *Williams v. Matthews Co.*, 499 F.2d 819 (8th Cir. 1974), *cert. denied*, 419 U.S. 1021 (1974).

pose sufficiently compelling to override any discriminatory impact;

(2) The challenged practice must effectively carry out the business purpose it is alleged to serve;

(3) There must be available no acceptable alternative policies or practices which would better accomplish the business purpose advanced, or accomplish it equally well with a lesser discriminatory impact.¹⁹⁹

The regulations issued by the Savings and Loan Commissioner contain detailed guidelines for determining whether a discriminatory practice is required to achieve an overriding legitimate business purpose.²⁰⁰ Apart from the regulations, the criteria that will satisfy the defense of business necessity has developed primarily through case law. Although application of the criteria in the regulations or the criteria in the case law should yield the same result in a given case, the criteria from the two sources will be discussed separately.

A. Business Necessity Criteria Under the Regulations

The regulations issued by the Savings and Loan Commissioner state that the purpose of the regulations is to prevent discrimination in a manner "consistent with sound business practice."²⁰¹ In the section of the regulations prohibiting discrimination, moreover, the regulations state that no association shall engage in redlining, "unless the association can demonstrate that such consideration in the particular case is required to avoid an unsafe or unsound business practice."²⁰² In the subchapter entitled "Guidelines to Fair Lending,"²⁰³ the regulations define the conditions, characteristics, and trends in the neighborhood which the regulatory agency will consider required to avoid an unsafe or unsound business practice. The subchapter containing these guidelines, then, contains the criteria which the regulatory agency will accept as establishing an overriding legitimate business purpose.

Two of the factors that the Savings and Loan Commissioner considers sufficient to justify denial of a loan, although they may result in discrimination, are the *current* fair market value of the property²⁰⁴ and any geological hazards surrounding the property.²⁰⁵ An association may also deny the loan if it already has an unusually high concentration of loans in that census tract,²⁰⁶ since diversification of an association's loan portfolio is desirable.

199. 10 CAL. ADMIN. CODE §246.3(a)(2).

200. 10 CAL. ADMIN. CODE §246-246.7.

201. 10 CAL. ADMIN. CODE §245(b).

202. 10 CAL. ADMIN. CODE §245.2(a).

203. 10 CAL. ADMIN. CODE, Subchapter 24 (commencing with §246).

204. 10 CAL. ADMIN. CODE §245.3(a).

205. 10 CAL. ADMIN. CODE §245.3(d).

206. 10 CAL. ADMIN. CODE §245.3(c).

However, such a high concentration of loans in a historically redlined area would be unusual.

The most subjective criterion that an association may use to justify the denial of a loan, however, is the projection of the "future fair market value" of the property.²⁰⁷ The regulations provide that if an association can document factors that will cause the fair market value to decline during the early years of the mortgage term, the association may deny the loan or adjust the terms of the loan and require the borrower to pay a higher down payment, or higher monthly payments, or both.²⁰⁸ Allowing the associations to base their lending practices on the future of the neighborhood in which the property is located, however, involves the subjective judgment of the association in projecting the future decline of the neighborhood,²⁰⁹ and the institutions are able to use their own projection to deny the loan or to vary the terms. Even when the financial institution is allowed only to vary the terms of the mortgage, this will still have the probable effect of pricing most residents of redlined areas out of the market, since they are typically the least able to afford higher down payments or higher monthly payments. Thus, the practical effect of allowing associations to use the future fair market value of the property as a justification for denying or varying the terms of a loan, may be merely to sanction redlining on a more sophisticated level.²¹⁰

Thus, business necessity is a viable defense under the Savings and Loan Commissioner's regulations. The regulations contain an entire subchapter of guidelines which the associations may use to establish the business necessity defense.

B. Business Necessity Criteria Under Case Law

Financial institutions generally assert three main reasons for their reluctance to make loans in historically redlined areas: (1) the increased economic risks which the financial institutions perceive they are taking in these areas;²¹¹ (2) the fiduciary duty the institutions have to their depositors and shareholders;²¹² and (3) the belief that the institutions will be unable to sell these loans in the secondary mortgage market.²¹³ Each of the considerations advanced by the financial institutions will be examined in light of the three criteria for establishing business necessity that have been used by the federal courts in housing and employment discrimination cases. The results of this examination will determine whether financial institutions will be able to legally justify redlining practices by using a business necessity defense.

207. 10 CAL. ADMIN. CODE §245.3(b).

208. 10 CAL. ADMIN. CODE §245.3(b).

209. *Redline Hearings*, *supra* note 7, Dec. 5, 1975, at 6.

210. Renne, *Eliminating Redlining by Judicial Action: Are Erasers Available?*, 29 VAND. L. REV. 987, 1008 (1976).

211. See text accompanying notes 214-250 *infra*.

212. See text accompanying notes 251-271 *infra*.

213. See text accompanying notes 272-295 *infra*.

1. Perceived Risks

Financial institutions argue that certain economic factors increase their risks in redlined areas and thus motivate disinvestment. These are: higher administrative costs on loans and difficulty with loan repayment,²¹⁴ a higher ratio of foreclosures in these areas,²¹⁵ and property of inferior quality, which is poor collateral in the eyes of institutional lenders.²¹⁶ Each of these factors will be examined in light of the criteria required to establish a business necessity defense to determine whether these factors justify redlining practices by financial institutions.

First, lenders point out that administrative costs are higher on loans in redlined areas than on loans in other areas.²¹⁷ One reason is that loans in redlined areas tend to be smaller loans than loans in other areas, and if the costs for servicing a mortgage in terms of time and paperwork are fixed, then these costs will represent a larger percentage of a small loan than of a large loan.²¹⁸ Consequently, the smaller loan in a redlined area is relatively less profitable than a larger loan in another area. Higher administrative costs may also be incurred on mortgage loans in redlined areas because of the location of the mortgaged property.²¹⁹ If the property is located in an area where the threat of vandalism is high, the property may be inspected periodically by lenders concerned about their investment. To the lender, such inspections represent outlays of time and money which would be unnecessary if the property were located elsewhere.²²⁰

Lenders also cite difficulty with loan repayment as a problem with a loan in a redlined area.²²¹ Generally the income levels are lower and unemployment is higher in these areas.²²² Beyond the problem of complete failure to repay,²²³ the lender's costs may be increased by the letters, phone calls, and other actions required because of delinquent loan payments.²²⁴

In evaluating arguments by financial institutions that increased administrative costs justify discriminatory practices, it appears that the courts have balanced the impact of the increased costs on the business against the importance of the borrower's right not to be discriminated against in his application for a mortgage loan.²²⁵ The lender's increased administrative

214. Comment, *The Legality of Redlining Under the Civil Rights Laws*, 25 AM. U.L. REV. 463, 467 (1976).

215. *Redline Hearings*, *supra* note 7, June 16, 1975, no. 2, at 10-11.

216. Comment, *The Legality of Redlining Under the Civil Rights Laws*, 25 AM. U.L. REV. 463, 468 (1976).

217. *Id.* at 467.

218. *Id.*

219. *Id.*

220. *Id.*

221. *Id.*

222. *Redline Hearings*, *supra* note 7, June 16, 1975, no. 2, at 10.

223. See text accompanying note 227 *infra*.

224. Comment, *The Legality of Redlining Under the Civil Rights Laws*, 25 AM. U.L. REV. 463, 467 (1976).

225. See *id.* at 482.

costs include: (1) time and paperwork costs that represent a higher percentage of a small loan than of a large loan; (2) inspection costs due to the location of the property; and (3) costs for letters, phone calls, and other actions required because of delinquent loan payments. These costs would all appear to be minimal, however, and the loan in a redlined area is nevertheless profitable for the financial institution. Thus, in order for the business purpose involved to be sufficiently compelling to override any discriminatory impact, lenders would have to show evidence of a *substantial loss*, as opposed to minimum unprofitability, from previous lending in areas now redlined.²²⁶

Second, lenders point to the higher ratio of foreclosures in redlined areas as a disadvantage of making loans in these areas.²²⁷ Lenders state that their losses on foreclosed properties have been substantial.²²⁸ When there is a foreclosure, the property is often vandalized, and plumbing fixtures, electrical fixtures, doors, and other articles are removed from the premises, thereby requiring a substantial investment by the financial institution to rehabilitate the property to bring it up to code and make it saleable.²²⁹ Lenders also claim that these foreclosed properties have little or no resale value.²³⁰ Furthermore, lenders in California cannot, for all practical purposes, seek deficiency judgments from borrowers when there is a foreclosure and resale of property.²³¹ Consequently, the foreclosure results in a loss to the lender. Lenders emphasize, then, that when they are initially granting loans, they must seek property with reasonable marketability.²³²

Even if lenders can show that they will have substantial losses on foreclosed property in redlined areas, the lenders must still show that there is no alternative to redlining with a less discriminatory impact in order to establish the defense of business necessity.²³³ It can be argued that there are three alternatives to redlining that would not only have a less discriminatory impact than redlining, but would also aid in reducing the foreclosure rate to a point where the institution's losses would no longer be substantial. These are: (1) revision of the institution's policy for allowing forbearance payment once an individual misses a mortgage payment; (2) creation of mortgage counseling programs; and (3) placement of greater emphasis on the characteristics of the borrower in the initial underwriting process.

226. *Id.*

227. *Redline Hearings*, *supra* note 7, June 16, 1975, no. 2, at 10-11.

228. *Id.*

229. *Id.*

230. Comment, *Urban Housing Finance and the Redlining Controversy*, 25 CLEV. ST. L. REV. 110, 116 (1976).

231. *Redline Hearings*, *supra* note 7, June 16, 1975, no. 2, at 4. California law bars deficiency judgments where the property was financed by a purchase money mortgage, CAL. CODE CIV. PROC. §580b, and where the property is sold pursuant to a power of sale in either a mortgage or a deed of trust. CAL. CODE CIV. PROC. §580d.

232. *Redline Hearings*, *supra* note 7, June 16, 1975, no. 2, at 4.

233. See text accompanying note 199 *supra*.

Allowing forbearance payments once an individual misses a mortgage payment could greatly reduce the institution's mortgage foreclosure rate. Testimony at the Redline Hearings revealed that, currently, if a borrower is three months behind in payments and it can be shown that the individual can have his payments current within six months, the institution still will not postpone foreclosure.²³⁴ If the financial institution stands to lose substantially from the foreclosure itself, it would seem that the institution has nothing to lose in allowing the individual to catch up. By allowing the borrower to keep his home and the institution to get its money, this alternative would seem to be better in the long run for both the borrower and the financial institution.

Another alternative to redlining would be the creation of a mortgage counseling program for delinquent borrowers or for all borrowers in potentially redlined communities. Several of these programs have been undertaken in California on an experimental basis.²³⁵ One such counseling program in Oakland was shown to reduce the delinquency ratio from a national average of around 16 percent for the type of loan involved to approximately 1.5 percent.²³⁶ Establishment of counseling programs is, therefore, another alternative to redlining that could substantially reduce the financial institution's losses, and at the same time be beneficial for both the borrower and the lender.

A third alternative to redlining would be to place more emphasis on the borrower in the initial underwriting process, even though the lender must ultimately look to the security of the property itself. In proposing this alternative to redlining, the president of a savings and loan association²³⁷ has pointed out that the whole system of mortgage lending has become a bit dehumanizing and suggested a more personal interaction between the borrower and the financial institution.²³⁸ His contention is that if the institution underwrites a loan based on a personal knowledge and understanding of the borrower, then the lender has done the single most important thing it can do to control loss in single-family lending.²³⁹ The theory behind this approach is that if the borrower does not default on the mortgage payments, then there will be no foreclosure. This "personalization" theory may also help explain the success of counseling programs, since through counseling, the institu-

234. *Redline Hearings*, *supra* note 7, June 16, 1975, no. 2, at 37.

235. *E.g.*, *Redline Hearings*, *supra* note 7, June 27, 1975, no. 3 at 30 (Oakland); L.A. Times, Jan. 16, 1977, §VII, at 1, col. 5, at 16, col. 1. In discussing the need for mortgage counseling, Richard Farrer, President of the California Association of Realtors, points out that when you talk about people having competency to drive an automobile, it seems reasonable that they have to pass some kind of test in order to have a license. But we are willing to give people \$20,000 or \$25,000, put them inside of a single-family home and just let them sink because we never took the time to explain to them what their responsibilities are. *Redline Hearings*, *supra* note 7, June 23, 1975, at 77.

236. *Redline Hearings*, *supra* note 7, June 27, 1975, no. 3, at 30.

237. Larry Ulvestad, President of Anaheim Savings and Loan.

238. *Redline Hearings*, *supra* note 7, June 27, 1975, no. 3, at 23.

239. *Id.* at 19.

tion not only communicates specific information, but also shows an interest in and becomes familiar with the borrower.

Therefore, there are three alternatives to redlining that might aid in reducing the foreclosure rate that lenders have been experiencing in redlined areas. Since each of these alternative policies would have a less discriminatory impact than redlining itself, it would appear that the high rate of foreclosures experienced in redlined areas could not be used to establish business necessity as a defense.

Finally, in justifying their redlining practices, financial institutions assert that the inferior quality of property in redlined areas makes it poor collateral in the eyes of institutional lenders.²⁴⁰ Lenders state that the typical property in a redlined area is far below the quality and maintenance levels of suburban property.²⁴¹ Lenders also assert that property in redlined areas is old, has few amenities, and is subject to extensive repair and vandalisms.²⁴² The borrower's inability to keep up with maintenance is a real problem, since if the local housing and health officials put pressure on the borrower to bring the property up to standard and he cannot come up with the money, the property will be demolished,²⁴³ thereby destroying the lender's security for the loan.

Many lending institutions also consider a neighborhood undergoing racial transition to be one without stable property values.²⁴⁴ The underlying basis of long-term financing is stability over an equivalent period of years, and for this reason, areas in transition are often suspect to potential lenders.²⁴⁵ Although this fear of lower property values caused by racial mixing seems to be entrenched in the minds of lenders and consumers alike, the causal relationship between racial mixing and property value instability is not supported by hard evidence. In fact, studies show that racial mixing itself has no appreciable effect on property values.²⁴⁶

Lenders also point out that the proximity to the security property of abandoned buildings plus the increased likelihood of arson in abandoned buildings may weaken the security for a loan that is afforded by the property.²⁴⁷ There is really not much question that the *present* condition of a neighborhood has an effect on the value of the security property, and that as a matter of sound business judgement, the financial institution should consider such factors as abandoned buildings in close proximity to the

240. Comment, *The Legality of Redlining Under the Civil Rights Laws*, 25 AM. U.L. REV. 463, 468 (1976).

241. *Id.*

242. *Id.*

243. *Redline Hearings*, *supra* note 7, June 16, 1975, no. 2, at 15.

244. Duncan, Hood, & Neet, *Redlining Practices, Racial Resegregation, and Urban Decay: Neighborhood Housing Services as a Viable Alternative*, 7 URB. LAW. 510, 515 (1975).

245. *Id.* at 518.

246. *Id.* at 516-17.

247. Comment, *Urban Housing Finance and the Redlining Controversy*, 25 CLEV. ST. L. REV. 110, 133 (1976).

property as a factor in determining the property's value. However, the essence of redlining is the lender's projection of the economic *future* of a neighborhood and the subsequent refusal to make loans based on that projection.²⁴⁸ When financial institutions classify these areas as high risk, that prediction is simply too likely to become a self-fulfilling prophecy.²⁴⁹ Once a financial institution decides that an area is likely to become run-down, it will become run-down²⁵⁰ because there will be no money available in that area to keep property from declining or to make improvements.

Therefore, it would seem that the *present* inferior quality of property in a redlined area would constitute sufficient justification for a financial institution to refuse to make a loan based on business necessity. However, if financial institutions are allowed to use their own subjective judgment in projecting the future decline of the neighborhood, and are then allowed to use this projection as a basis for refusal to grant the loan, the practical result may be to merely sanction redlining on a more sophisticated level. Accordingly, courts that are balancing the interests of the financial institution against the interests of the borrower in a redlined area should find that the *possibility of future risk* on the part of the financial institution would not outweigh the *certainty of discriminatory impact* if the defense of business necessity is allowed. Financial institutions, then, arguably would not be able to establish the defense of business necessity based on the projected decline of a redlined neighborhood because their interest would not be sufficiently compelling to override any discriminatory impact.

Thus, it would appear that even though the economic factors of increased administrative costs, difficulty with loan repayment, higher ratios of foreclosures, and inferior housing quality do exist with loans in redlined areas, the defense of business necessity still cannot be used to justify discriminatory lending practices that are based on these factors. The lender's increased administrative costs and difficulty with loan repayment cannot be used to constitute business necessity, since these increased costs indicate only that loans in redlined areas are relatively less profitable than loans in other areas. In order for the business purpose involved to be sufficiently compelling to override any discriminatory impact, lenders would have to show evidence of a *substantial loss*, as opposed to minimum unprofitability, from previous lending in areas now redlined. The lender's higher ratios of foreclosures in redlined areas also cannot be used to constitute business necessity, since there are alternatives to redlining which have a less discriminatory impact on the borrower. The inferior housing quality that exists in many redlined areas could be used to constitute the defense of business necessity as long as the institution bases its decision on the *present* inferior quality rather than the

248. See text accompanying note 209 *supra*.

249. *Redline Hearings*, *supra* note 7, June 16, 1975, no. 1, at 5.

250. *Id.*

projected inferior quality of the property. When the financial institution claims that the quality of the property will be inferior at some future point in time, the institution has only a *possibility of future risk* if the loan is actually made. The financial institution's interest in protecting itself from this possibility of future risk is arguably not sufficiently compelling to outweigh the *certainty of discriminatory impact* if the defense of business necessity were allowed.

2. *Fiduciary Duty as Corporate Directors*

The lending institutions point out that they have a fiduciary duty to their depositors and shareholders, and that they can neither legally nor economically extend credit when the prospects for loss exceed the prospects for gain.²⁵¹ The lenders assert that to do so would constitute an unsafe and unsound business practice in the eyes of the regulatory agencies.²⁵² The lending institutions thus argue that their fiduciary²⁵³ responsibility to their depositors and shareholders constitutes the defense of business necessity and keeps them from being able to make more loans in redlined areas.

With regard to the fiduciary obligations of officers and directors of financial institutions, however, the question arises whether the directors owe a duty *solely* to the depositors and investors of that institution, or whether there is a further duty to the community from which the institution draws its depositors and to the welfare of that community.²⁵⁴ Given the choice between a very safe loan and a risky loan, is the financial institution compelled to take part in some of the risky loans for social betterment?²⁵⁵

The financial industry is convinced that making more loans in redlined areas would mean the neglect of their duty to their depositors and shareholders.²⁵⁶ They contend that depositors are guaranteed an annual interest rate in return for their deposits. In order to insure that they will be financially able to pay this annual interest rate, the financial institutions must invest the depositor's dollars within reasonable bounds.²⁵⁷ The officers and directors also have a duty to the shareholders to invest the institution's funds in ventures where a reasonable rate of return on the money may be expected.²⁵⁸

Financial institutions recognize that, to a certain extent, the public interest

251. *Id.* at 26-27.

252. *Id.*

253. Directors of a corporation, while not strictly trustees, are fiduciaries, and occupy a fiduciary relationship to the corporation and its shareholders. Hence, it is their duty to promote the best interests of the shareholders and the corporation. *See, e.g.,* Brown v. North Ventura Road Dev. Co., 216 Cal. App. 2d 227, 232-33, 30 Cal. Rptr. 568, 571 (1963); Remillard Brick Co. v. Remillard-Dandini Co., 109 Cal. App. 2d 405, 419, 241 P.2d 66, 74 (1952).

254. Earthman, *Residential Mortgage Lending: Charting a Course Through the Regulatory Maze*, 29 VAND. L. REV. 957, 984 (1976) [hereinafter cited as Earthman].

255. *Redline Hearings*, *supra* note 7, June 23, 1975, at 4.

256. Comment, *Urban Housing Finance and the Redlining Controversy*, 25 CLEV. ST. L. REV. 110, 116 (1976).

257. *See Redline Hearings*, *supra* note 7, June 16, 1975, no. 2, at 2.

258. *See id.*

lies in their making more loans in redlined areas.²⁵⁹ But the lenders maintain that the state cannot mandate that they risk the depositor's funds for the sake of another social need. The lenders maintain that it is society's risk as differentiated from the depositor's risk.²⁶⁰

The argument that directors are fiduciaries and must act in the best interests of their depositors ignores the fact that it may well be the depositors themselves who are being denied mortgage money. Most savings and loan associations are mutually owned, and this mutual ownership envisions participation by persons who are in the savings and loan association's primary service area.²⁶¹ Residents of an area seeking mortgage financing might therefore tend to start at either a neighborhood financial institution or at one where they are already a depositor. It can hardly be said to be in the best interest of a depositor to take his money, but refuse to return it in the form of mortgage loans.

If mortgage loan availability is one of the returns that a depositor may reasonably expect from a financial institution, then it would appear that the institution's fiduciary duty to its depositors could not be used to justify redlining practices. Under these circumstances, the fiduciary duty would not satisfy the criteria required to constitute business necessity because it does not effectively carry out the purpose it is alleged to serve.²⁶²

Apart from the status of the borrower as a depositor, however, the institution violates its duty to its depositors and shareholders only if it makes decisions which jeopardize the fiscal soundness of the institution. Discussion in the previous section indicated that any practice that can be shown to result in a substantial loss to the institution, as opposed to minimal unprofitability, could be avoided by the defense of business necessity.²⁶³ Accordingly, under the regulations and under the statutes which may be used to challenge redlining practices, the financial institutions would not be required to make loans that would jeopardize the fiscal soundness of the institution.

The institutions can best fulfill their fiduciary obligations to their depositors and shareholders by looking for the least discriminatory alternative that complies with laws applicable to redlining and yet still allows them to provide a reasonable return on the institution's dollar. There are several such alternatives to outright denial of loans in redlined areas which would allow the directors to fulfill their duties to their depositors and shareholders, yet which would have a less discriminatory impact on residents of redlined areas. One such alternative to loan denial is the creation of an assigned risk pool similar to that used in auto insurance for people who would otherwise

259. See *Redline Hearings*, *supra* note 7, June 23, 1975, at 36.

260. *Id.*

261. See *Redline Hearings*, *supra* note 7, June 16, 1975, no. 1, at 25.

262. See text accompanying note 199 *supra*.

263. See text accompanying note 226 *supra*.

be considered uninsurable by the insurance companies.²⁶⁴ Under this program each financial institution would put a certain amount of money into the pool and make a certain number of loans in redlined areas, and then all participating lenders would share any losses proportionately rather than allowing the loss to fall totally on any one lender.²⁶⁵ This alternative seems to have been embraced voluntarily by many California financial institutions, since there are currently 27 lending institutions in California that pooled over \$30 million over a three-year period in a program of this type.²⁶⁶ This type of program has barely scratched the surface of the need in California, but at least it is a beginning.²⁶⁷

The question remains whether directors owe a duty *solely* to the depositors and investors of that institution, or whether there is a further duty to the community from which the institution draws its depositors and to the welfare of that community. At the Redline Hearings, witnesses indicated that local financial institutions do have a legal responsibility to the community in which they were chartered.²⁶⁸ These witnesses find support for their position in statutory language indicating that applications for new charters must include information on whether there is a "necessity for the proposed association in the community to be served by it."²⁶⁹ They reason that if the institution was chartered to fulfill a need in a particular community, then the institution is under a legal obligation to fulfill the financial needs of that community. Financial industry spokesmen, on the other hand, contend that these statutes impose neither an explicit nor an implicit duty on financial institutions to invest in specific neighborhoods.²⁷⁰ Rather, the investment decision is left to the determination of the institutions themselves on the basis of demands for mortgage funds and the exercise of sound business judgment evaluating risks and potential profitability.²⁷¹

It would appear that the statutes governing charter requirements for financial institutions do not expressly create an affirmative duty to lend in the area in which the institution is located. However, the institution is legally prohibited from redlining, and the institution can be expected to receive more applications for financial assistance from the area in which it is located than from other areas. Consequently, complete failure of the institution to lend in the area in which it is located might be an indication that redlining is occurring, and might be cause for inquiry into the institution's lending policies. Financial institutions would not be able to justify their

264. *Redline Hearings*, *supra* note 7, June 27, 1975, no. 3, at 28-29.

265. *Id.*

266. *Id.*

267. *Redline Hearings*, *supra* note 7, June 23, 1975, at 15.

268. *Redline Hearings*, *supra* note 7, written testimony submitted by Merle Mergell, Mayor, City of Inglewood, California, at 4.

269. *Id.*

270. *Redline Hearings*, *supra* note 7, June 16, 1975, no. 1, at 23.

271. *Id.* at 23-24.

failure to lend in redlined areas, then, on the basis of their fiduciary duty to their shareholders and depositors for several reasons. First, mortgage loans may be one of the returns for his deposit that a depositor may reasonably expect from a financial institution. If so, the institution's fiduciary duty to its depositors could not be used to constitute business necessity since it would not effectively carry out the purpose it is alleged to serve. Second, the institution would be violating its duty to its depositors and shareholders only if they make decisions which jeopardize the fiscal soundness of the institution. Making loans in redlined areas would not necessarily create such jeopardy. Third, the financial institutions cannot use their fiduciary duty to depositors and shareholders to constitute the defense of business necessity because there are alternatives to redlining such as assigned risk pools, that would have a less discriminatory impact on residents of redlined areas. Finally, although the financial institution probably does not have an affirmative duty to lend in the area in which it is located, in addition to its duty to its depositors and shareholders, complete failure to make loans in that area may indicate that redlining is occurring, and may be cause for scrutiny of the institution's lending policies.

3. Access to Secondary Mortgage Market

Financial institutions rely heavily on their ability to sell mortgages in the secondary mortgage market, and the institutions claim that loans made in redlined areas cannot be sold in this market.²⁷² The institutions maintain that this lack of access to the secondary mortgage market for loans made in redlined areas constitutes the defense of business necessity.

The secondary mortgage market is generally a place where mortgages can be bought and sold.²⁷³ There are currently three quasi-governmental agencies that provide a secondary mortgage market: the Federal Home Loan Mortgage Corporation (known as "Freddie Mac"),²⁷⁴ the Government National Mortgage Association ("Ginnie Mae"),²⁷⁵ and the Federal National Mortgage Corporation ("Fannie Mae").²⁷⁶ The purpose of the secondary mortgage market is to provide a place where financial institutions can make loans to the borrower and handle the bulk of real estate closings, and then sell the mortgage to one of the three agencies in the secondary mortgage market. After the mortgage is sold, the financial institution that made the loan generally retains the servicing of the mortgage, which includes any further communication with the borrower.²⁷⁷

272. *Redline Hearings*, *supra* note 7, June 16, 1975, no. 2, at 11.

273. Earthman, *supra* note 254, at 973-74.

274. *Id.* at 974. Freddie Mac is a private agency created by the Emergency Home Finance Act of 1970, 12 U.S.C. §§1451-1459 (1970).

275. Earthman, *supra* note 254, at 976. Ginnie Mae is a corporate instrumentality of the federal government within HUD. *Id.*

276. *Id.* Fannie Mae is privately owned and holds the largest residential mortgage portfolio in the world. *Id.*

277. *Redline Hearings*, *supra* note 7, June 16, 1975, no. 2, at 25.

The ability to sell loans in the secondary mortgage market has several advantages.²⁷⁸ First, the funds generated from the sale can be committed once again to the residential market, thus increasing the number of residential mortgage loans made. Second, the ability to sell loans in the secondary mortgage market provides and allows better utilization of the institution's available capital.

Financial institutions maintain that they are virtually unable to sell loans made in redlined areas in the secondary mortgage market.²⁷⁹ One reason is that the secondary market agencies are more reluctant to lend in redlined areas than the local financial institutions are, because the secondary market agencies do not know the areas as well as the neighborhood lenders do.²⁸⁰ Another obstacle to selling loans in the secondary market is that enabling legislation for the secondary market agencies provides that the type of loans that can be purchased should be the type that are normally made and meet the quality normally made by institutional investors.²⁸¹ Consequently, financial institutions say it would be contrary to the legislative mandate of these agencies to take conventional loans that are not of normal underwriting quality.²⁸² Furthermore, the regulations applicable to the secondary mortgage market have very specific repurchase provisions under which the financial institution could be forced to repurchase any mortgages made in violation of the secondary market's regulations.²⁸³ The forced repurchase of mortgages would obviously have a very detrimental effect on financial institutions.

Thus, since every financial institution depends to some extent on the secondary mortgage market, the institutions claim that out of business necessity, they must comply with the regulations that preserve their access to that market.²⁸⁴ In other words, lenders are arguing that they can only make loans that they know they can sell in the secondary market and that, in this sense, they are only loan processing agents.²⁸⁵ In fact, the financial institutions assert that no government insurance is available for loans in redlined areas, since FHA and VA also engage in redlining,²⁸⁶ and that the secondary mortgage market will not participate in these areas because they consider it "high-risk lending."²⁸⁷ The financial institutions therefore contend that mortgages in redlined areas cannot even be considered to be liquid assets of the institutions.²⁸⁸

278. Earthman, *supra* note 254, at 983.

279. *Redline Hearings*, *supra* note 7, June 16, 1975, no. 2, at 11.

280. *Id.* at 6.

281. *Id.* at 25-26.

282. *Id.* at 26.

283. Earthman, *supra* note 254, at 984.

284. *See id.*

285. *Redline Hearings*, *supra* note 7, June 16, 1975, no. 1, at 28.

286. E.g., *Redline Hearings*, *supra* note 7, June 16, 1975, no. 1, at 16. *See Redline Hearings*, *supra* note 7, June 16, 1975, no. 2, at 9.

287. *Redline Hearings*, *supra* note 7, June 16, 1975, no. 2, at 11.

288. *Id.*

There is evidence, however, that the three agencies involved in the secondary mortgage market do not all engage in redlining, or at least not all to the same degree.²⁸⁹ "Freddie Mac" may engage in redlining most blatantly, since their regulations provide that in determining an acceptable term of years for a mortgage, the original term may not exceed 30 years, "or such lesser term as is appropriate, given the character, age, and *location of the mortgage premises*."²⁹⁰ Thus, tacit recognition is made that some locations are less desirable than others, and that in such instances, appropriate modifications may be made to the terms of any loan on property located in the area.²⁹¹ The regulations for "Fannie Mae" also refer to the necessary evaluation of the "neighborhood" for use in appraising the premises being considered for a mortgage.²⁹² The regulations allow the appraiser to consider the impact of social and economic characteristics of the neighborhood which are likely to affect the value of the security property.²⁹³ However, the appraiser is directed to report detrimental neighborhood conditions "in factual specific terms by giving the address of the affected properties and an exact description of the nature of the conditions involved in each case."²⁹⁴ Thus, it appears to be the intent of "Fannie Mae" to require an individual analysis on a premises-by-premises basis, rather than to allow sweeping generalizations that could adversely affect the making of loans to the entire neighborhood.²⁹⁵

If "Fannie Mae" does not in fact engage in redlining, then the financial institution's asserted inability to sell loans in the secondary mortgage market may not be convincing. At a minimum, it would seem that financial institutions should be required to make loans in redlined areas which they consider to be sound loans, and then attempt to sell these loans in the secondary market. At the present time, financial institutions are attempting to justify their reluctance to make any loans in redlined areas on the grounds that *if* such loans were made, the institutions *would be* unable to sell them in the secondary mortgage market. The agencies in the secondary market should at least be put to the test to see whether their former redlining practices would continue in the face of increased lending by local financial institutions.

It would thus seem that the financial institutions could not use limited access to the secondary mortgage market to constitute the defense of business necessity. If "Fannie Mae" does not engage in redlining or engages in redlining to a lesser extent than the other agencies in the secondary mortgage

289. See Earthman, *supra* note 254, at 975, 977.

290. *Id.* at 975.

291. *Id.*

292. *Id.* at 977.

293. *Id.*

294. *Id.*

295. *Id.*

market, then attempting to sell mortgages in redlined areas to "Fannie Mae" may be an alternative to redlining that would have a less discriminatory impact on borrowers in redlined areas than the presumed inability to sell mortgages in the secondary market.

GOVERNMENT INVOLVEMENT

Even though financial institutions concede that increased lending activity in redlined areas is necessary if the continued decline of these areas is to be averted,²⁹⁶ they are nevertheless reluctant to increase the extent of their lending unless the government agrees to participate with them in any losses that may occur. Financial institutions emphasize that the responsibility for the decline of redlined neighborhoods is shared, and maintain that it would be unjust to require the financial industry alone to bear the entire financial burden of restoring these communities.²⁹⁷ The financial industry contends that a cooperative effort between government and private industry is the only way to effectively stop the deterioration of California's neighborhoods.²⁹⁸ In response to this concern by the financial industry, the state has begun to participate with financial institutions in increasing the extent of mortgage lending in redlined areas.

The financial industry was particularly anxious that the state provide mortgage insurance for loans made in redlined areas.²⁹⁹ The financial industry requested that the state provide a mortgage insurance agency that would participate in any losses should they occur.³⁰⁰ In response to this request, the Housing Rehabilitation Insurance Fund was established on September 26, 1975.³⁰¹ The law creating the fund authorizes the California Housing Finance Agency to conduct a loan insurance program to insure loans made by the Agency or by qualified mortgage lenders.³⁰² It was the intent of the legislature in creating this fund to establish a program of loan insurance to encourage and facilitate the preservation of existing housing and improve housing opportunities for persons and families of low or moderate income.³⁰³ In administering the fund, the Agency will hold public hearings and establish priorities for the allocation of loan-insurance assistance among eligible areas throughout the state.³⁰⁴

296. *Redline Hearings*, *supra* note 7, June 27, 1975, no. 3, at 27.

297. *Redline Hearings*, *supra* note 7, June 23, 1975, at 48.

298. *Redline Hearings*, *supra* note 7, June 16, 1975, no. 2, at 3.

299. *Id.* at 11.

300. *Id.*

301. CAL. HEALTH & SAFETY CODE §42000.

302. CAL. HEALTH & SAFETY CODE §42062. Insurance may be provided for loans for rehabilitation, refinancing in connection with rehabilitation, acquisition of residences, or construction or mortgage financing. CAL. HEALTH & SAFETY CODE §42062.

303. CAL. HEALTH & SAFETY CODE §42001. The Housing Rehabilitation Insurance Fund was created by a five million dollar appropriation from the General Fund. This money must be repaid to the General Fund by Jan. 1, 1986. CAL. HEALTH & SAFETY CODE §42080. The operating expenses of administering the fund and the money to be repaid to the General Fund will come from insurance premiums which the Agency will add to the interest rates of insured loans. CAL. HEALTH & SAFETY CODE §42065.

304. CAL. HEALTH & SAFETY CODE §42045.

The Agency typically will not insure loans for 100 percent of the outstanding indebtedness, but will only share with private lenders in any losses that may occur.³⁰⁵ Most loans will be insured "only for such percentage of the amount of risk as the agency determines is necessary to induce approved lending institutions to make such loans."³⁰⁶

Through its Housing Rehabilitation Insurance program, the state will share with private lending institutions the risk of lending in previously redlined areas. By this method, private lenders are now able to get back into previously redlined areas without some of the risk that would otherwise be involved if the state were not participating. One consumer group has pointed out that a financial institution's initial investment in a redlined area is very important, because once the lending institutions have a significant financial stake in these neighborhoods, the problems associated with redlining may quickly disappear.³⁰⁷

In addition to its involvement in the mortgage insurance area, the Housing Finance Agency was created to make mortgage financing available in geographical areas in which private lenders have been unable or unwilling to commit sufficient funds for residential lending.³⁰⁸ Basically, the Housing Finance Agency is designed to stimulate lending by private financial institutions by contracting with mortgage lenders for the initiation and servicing of mortgage loans,³⁰⁹ by lending funds to mortgage lenders and requiring the proceeds to be used to finance housing developments,³¹⁰ or by purchasing³¹¹ or insuring³¹² loans made by mortgage lenders for financing or refinancing housing developments. Rather than making mortgage loans itself, the Housing Finance Agency is really designed to act as a catalyst to encourage the investment of private capital in the housing market in a public/private partnership.³¹³

The state's creation of the Housing Rehabilitation Insurance Fund and the Housing Finance Agency indicates that the government is responsive to requests by the financial industry for finding solutions to the problems of redlining. This responsiveness demonstrates that the state is willing to do its part to end redlining in California.

305. CAL. HEALTH & SAFETY CODE §42061.

306. CAL. HEALTH & SAFETY CODE §42061.

307. *Redline Hearings*, *supra* note 7, June 16, 1975, no. 1, at 20.

308. CAL. HEALTH & SAFETY CODE §41003(c). The primary purpose of the Agency is to meet the housing needs of low or moderate income persons and families. CAL. HEALTH & SAFETY CODE §41331.

309. CAL. HEALTH & SAFETY CODE §41388.

310. CAL. HEALTH & SAFETY CODE §41465.

311. CAL. HEALTH & SAFETY CODE §41455.

312. CAL. HEALTH & SAFETY CODE §41457.

313. Senator George N. Zenovich, Press Release, June 30, 1975, at 2 (copy on file at the *Pacific Law Journal*).

CONCLUSION

It is clear that redlining is practiced by financial institutions in California, and that the resultant lack of mortgage financing has caused or contributed to the deterioration of residential neighborhoods. It is also clear that the availability of home loans is essential to the preservation of California's existing housing stock. To determine the full extent of the redlining problem in California, however, there must be disclosure by financial institutions of what their lending practices actually are. Although data has been collected by agencies regulating the financial institutions for some time, the information is inadequate to establish an accurate lending profile. To remedy that inadequacy, California has recently taken several steps to require further disclosure by financial institutions. Regulations were adopted by the Savings and Loan Commissioner requiring public disclosure of data on all loans made by state-licensed savings and loan associations after August 1, 1976. In addition to requiring public disclosure, the regulations require disclosure to the individual loan applicant of information designed to enable the applicant to determine whether he has been the victim of discriminatory lending practices.

The Department of Housing and Community Development was given responsibility for developing a California Statewide Housing Plan that will contain an evaluation and summary of housing conditions throughout the state. The Department of Housing and Community Development was also directed to establish a statewide housing information system, and was given authority to provide a statistics and research service for the collection and dissemination of information affecting housing and community development.

Although California now has very extensive disclosure requirements for financial institutions, there may be some problem in disseminating available information to interested consumers. Thus, in order for a truly comprehensive picture of mortgage lending practices in California to emerge, it is recommended that *all* data related to housing finance be collected and disseminated through one central source, the Department of Housing and Community Development.

In addition to obtaining data on redlining practices, California borrowers can also challenge the legality of the redlining practices of financial institutions. Although a variety of legislation has been introduced in California that was designed to make redlining illegal, there is currently no statute in California that *expressly* makes redlining illegal. However, redlining by state-chartered savings and loan associations is prohibited by regulations issued by the Savings and Loan Commissioner that were effective August 1, 1976. The redlining practices of any financial institution may also be challenged under the Unruh Civil Rights Act, the Rumford Fair Housing

Act, or under three federal civil rights statutes: the Civil Rights Act of 1866, the Fair Housing Act of 1968 and the Civil Rights Act of 1964.

Even if a violation of a state or federal statute is found, however, a financial institution which can establish the affirmative defense of business necessity may still be justified in continuing the practice. The rationale of the business necessity defense is that a practice or policy which is absolutely vital to the proper functioning of the enterprise may be sustained even in the face of its discriminatory effect. The real extent to which redlining practices may be controlled in California thus depends on the extent to which business necessity justifies redlining practices.

The financial institution's reluctance to make loans in historically redlined areas is generally based on three main considerations: the increased economic risks which the financial institutions perceive they are taking in these areas, the fiduciary duty the institutions have to their depositors and shareholders, and the belief that they will be unable to sell these loans in the secondary mortgage market. However, it is arguable that none of these considerations is sufficient to constitute the defense of business necessity, because in every case there are alternatives to redlining that would accomplish the financial institution's purpose in making the loan but would have a less discriminatory impact on borrowers in redlined areas.

Financial institutions have also emphasized that they are not solely responsible for the decline of redlined neighborhoods and the institutions have requested a cooperative effort between government and private industry in attempting to stop the deterioration of California's neighborhoods. In response to this request by the financial industry, California has created the Housing Rehabilitation Insurance Fund to insure loans made by private lenders in redlined areas and the Housing Finance Agency to act as a catalyst to encourage the investment of private capital in redlined areas.

Thus, both the State of California and the private financial institutions are taking steps to eliminate redlining in California. Through this public/private partnership, it is hoped that the further deterioration of California's urban neighborhoods can be effectively controlled.

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